International—Banker's Acceptances

Effective date May 1996

Section 7060.1

One method of financing international trade is by the use of a banker's acceptance. This instrument may be used to finance all of the successive stages of the movement of goods through the channels of trade from the point of origin to the final destination.

A banker's acceptance is an order in the form of a time draft (also referred to as a bill of exchange or a usance draft) drawn by one party (the drawer) in favor of itself or another party (the payee), addressed to (drawn on) a bank (the drawee), and accepted by that bank to pay the holder a certain sum on or before a specified date. The bank's acceptance of this order from the drawer, by stamping "ACCEPTED" across the face of the draft and dating and signing the stamp, is a formal acknowledgment of the obligation and constitutes an unconditional promise by that bank to honor the time draft at maturity. The drawee bank creating the acceptance is primarily liable for the instrument while the payee, as first endorser, is secondarily liable for paying the holder in due course. If the drawee (acceptor) is other than a bank, the instrument is a trade acceptance, not a banker's acceptance.

Most banker's acceptances are used to finance trade transactions. Accordingly, acceptances are often created in connection with a letter of credit, although they may arise in connection with collection or open-account transactions. (See section 7080, "International—Letters of Credit.") In general, acceptance credit is considered self-liquidating in that it must provide the means for its own payment at maturity. To accomplish this, the acceptance must be based on a specific trade transaction in which goods are being shipped before entering the channels of trade. There should be satisfactory evidence to indicate that the draft, when created, is based on an actual shipment or storage and that, at maturity of the draft, the proceeds from the sale of the goods will be used to settle the draft. To a lesser extent, acceptances also finance the domestic shipment of goods and domestic or foreign storage of readily marketable staples.

The payee of the acceptance may hold an acceptance until maturity, discount it with his or her bank, or sell it in the acceptance market. When a bank discounts (purchases) its own acceptance for the payee, its "Customer's Liability on Acceptances" (asset) and "Bank's Liability on Acceptances" (liability) accounts are reduced, and the discounted acceptance is recorded with other loans and discounts. If the accepting bank subsequently rediscounts (sells) the acceptance in the market, that acceptance is rebooked as "Customer's Liability on Acceptances" and "Bank's Liability on Acceptances," and the loan and discount accounts are reduced. Rediscounted acceptances are not considered borrowings. The customer's liability on acceptances is reduced by a customer's prepayment or anticipation of an acceptance outstanding. The bank's liability is not similarly reduced by an anticipation.

The established market for banker's acceptances in the United States is regulated by the Federal Reserve System. Federal Reserve Banks are authorized to discount or purchase eligible banker's acceptances subject to qualitative and quantitative limits, thus providing a source of liquidity to the selling banks. The creation of banker's acceptances is governed by section 13 of the Federal Reserve Act, which establishes criteria that must be met for the instrument to be eligible for either discount or purchase by a Federal Reserve Bank. The rules governing whether an acceptance meets the eligibility requirements for discount or purchase are important for two major reasons. First, acceptances meeting the conditions of eligibility are more readily salable in the market than acceptances that do not satisfy these conditions and, as such, provide a greater degree of liquidity for the accepting bank. Second, ineligible acceptances, unlike those that are eligible, are subject to reserve maintenance requirements, thus raising the cost to the borrower over that of an eligible acceptance. The examiner must be familiar with the criteria used for determining eligibility for discount or purchase by a Federal Reserve Bank.

Section 207 of the Bank Export Services Act (title II of P.L. 97-290), which amended section 13 of the Federal Reserve Act (12 USC 372), limits the aggregate amount of eligible banker's acceptances that may be created by a member bank to 150 percent (or 200 percent with the permission of the Board) of its paid-up and unimpaired capital stock and surplus. In addition, a member bank is prohibited from creating eligible banker's acceptances for any one person in the aggregate in excess of 10 percent of the institution's capital. Eligible banker's acceptances growing out of domestic transactions are not to exceed 50 percent of the aggregate of all eligible acceptances authorized for a member bank. All of the foregoing limitations are also applicable to U.S. branches and agencies of foreign banks that are subject to reserve requirements under section 7 of the International Banking Act of 1978 (12 USC 3105).

Banker's acceptances as a source of financing and investment offer significant advantages to borrowers, accepting banks, and investors alike. Over the years, a banker's acceptance has often been a cheaper financing vehicle than a loan since it is readily marketable, considered an important secondary reserve for the accepting bank, and a relatively secure investment to the investor because of its two-name backing.

1. To determine if objectives, policies, practices, procedures, and internal controls for banker's acceptances are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To determine the scope and adequacy of the audit function as it applies to banker's acceptances.
4. To evaluate the portfolio for documentation and collateral sufficiency, credit quality, and collectibility.
5. To determine compliance with applicable laws and regulations.
6. To recommend corrective action when objectives, policies, practices, procedures, or internal controls are deficient or when violations of laws and regulations have been cited.

1. If selected for implementation, complete or update the banker's acceptance section of the Internal Control Questionnaire.
2. Determine the scope of the examination based on the evaluation of internal controls and the work performed by internal and external auditors.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
4. Obtain a trial balance of the customer liability records and:
   a. Reconcile balances to department controls and the general ledger.
   b. Review reconciling items for reasonableness.
5. Using an appropriate technique, select borrowers for examination.
6. Prepare credit line cards to include:
   a. Customer's aggregate banker's acceptance liability.
   b. Banker's acceptances aggregating the customer's total liability, listing:
      - Current balance of the acceptance.
        — Indicate any prepayments (anticipations) and portions sold under participation certificate.
      - Date the acceptance was created.
      - Tenor of the acceptance (give exact maturity date, if specified).
      - Type of acceptance.
        — Import.
        — Export.
        — Third country shipment.
        — Domestic shipment.
        — Storage.
        — To create dollar exchange.
        — Working capital and/or pre-export.
        — Refinancing of sight letters of credit.
        — Current status of the acceptance.
7. Obtain the following information, if applicable to banker's acceptances, which may necessitate inclusion of additional customers (borrowers) in the credit review:
   a. Delinquencies.
   b. Participations purchased and sold (including syndicate participations).
      - Acceptance participations sold.
      - Acceptance pool participations (borrowings).
   c. Loan commitments and other contingent liabilities.
   d. Extensions of credit to major stockholders, officers, directors and their interests.
   e. Extensions of credit to executive officers, directors and their interests of correspondent banks.
   f. Miscellaneous loan debit and credit suspense accounts.
   g. Criticized shared national credits (applicable foreign credits).
   h. Interagency Country Exposure Review Committee determinations.
   i. Extensions of credit considered "problem loans" by management.
   j. Information on directors, executive officers, principal shareholders and their interests.
   k. Specific guidelines in the lending policy pertaining to banker's acceptances.
   l. Each officer's current lending authority.
   m. The current fee structure.
   n. Any useful information resulting from the review of the minutes of the Loan and Discount Committee or any similar committee.
   o. Reports furnished to the Loan and Discount Committee or any similar committee.
   p. Reports furnished to the directorate.
   q. Loans criticized during the previous examination.
8. Review the information received and perform the following for:
   a. Participations purchased and sold:
      - Test participation certificates and records and determine that the parties share in the risks and contractual payments according to the agreement.
      - Determine that the books and records of the bank properly reflect the bank's liability.
      - Investigate any participations sold immediately prior to the date of examination to determine if any were sold to

avoid possible criticism during the examination.

b. Loan commitments (including acceptance commitments) and contingent liabilities.
   - Analyze the commitment or contingent liability if the borrower has been advised of the commitment together with the combined amounts of the current loan balance, if any.

c. Banker's acceptances created for officers and directors of other banks:
   - Investigate any circumstances which indicate preferential treatment.

d. Miscellaneous loan debit and credit suspense accounts:
   - Discuss with management any large or old items relating to banker's acceptances.

e. Shared national credits:
   - Compare the schedule of banker's acceptances included in the Uniform Review of National Credits Program to the sample selection to determine which banker's acceptances in the sample are portions of shared national credits (including applicable foreign credits).
   - For each banker's acceptance so identified, transcribe appropriate information from the schedule to line sheets and return the schedule. No further examination procedures are necessary for this area.

f. Cross-border lending:
   - Review credit risk without regard to cross-border considerations which will be analyzed separately. No further examination procedures are necessary in this area.

g. Loans criticized during the previous examination:
   - Determine disposition of banker's acceptances so criticized by transcribing:
     — current balance and payment status, or
     — date the banker's acceptance was repaid and the source of repayment.

9. Transcribe or compare information from the above schedules to credit line cards, where appropriate, and indicate any past-due status.
10. Prepare a credit line card for any banker's acceptance not in the sample which, based on information derived from the above schedules, requires an in-depth review.
11. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts, and other loan areas and, together, decide who will review the borrowing relationship. Pass or retain completed credit line cards.
12. Obtain credit files for all borrowers for whom credit line cards were prepared and complete credit line cards, where appropriate. To analyze the loans, perform the following procedures:
    a. Analyze balance sheet and profit and loss figures as shown in current and preceding financial statements, and determine the existence of any unfavorable trends.
    b. Relate items or groups of items in the current financial statements to other items or groups of items set forth in the statements, and determine the existence of any favorable or adverse ratios.
    c. Review components of the balance sheet as shown in the current financial statements and determine the reasonableness of each item as it relates to the total financial structure.
    d. Review supporting information for the major balance sheet items and the techniques used in consolidation and determine the primary sources of repayment and evaluate their adequacy.
    e. Review compliance with the provisions of acceptance agreements.
    f. Review the digest of officer's memoranda, mercantile reports, credit checks and correspondence to determine the existence of any problems which might deter the contractual liquidation program.
    g. Relate any collateral values to outstanding debt, including margin and cash collateral deposits.
    h. Compare fees charged to the fee schedule(s) and determine that the terms are within established guidelines.
    i. Compare the amount of banker's acceptances outstanding with the lending officer's authority.
    j. Analyze secondary support afforded by guarantors.
    k. Ascertain compliance with the bank's established banker's acceptance policy.

13. For banker's acceptances in the sample, check the central liability file on borrowers indebted above the cutoff and on borrowers displaying credit weaknesses or suspected of having additional liability in loan areas.
14. Transcribe significant liability and other information on officers, principals and affiliations of appropriate obligors contained in the sample. Cross-reference line sheets to borrowers, where appropriate.
15. Determine compliance with laws, regulations, and eligibility requirements regarding banker's acceptance financing by performing the following steps:
    a. Determine bank compliance with state limits or the aggregate amount of acceptances that may be created for any one customer, and acceptances created to furnish dollar exchange.
    b. Determine compliance with stipulated aggregate liability limitations on acceptances outstanding. (See Federal Reserve Act, section 13 for single person and aggregate limitation provisions.)
    c. Determine which acceptances are ineligible and therefore subject to loan limitations imposed by state law. In general, an eligible banker's acceptance is one which must arise out of a transaction described in section 13 of the Federal Reserve Act. For details of eligibility requirements, refer to the operating provisions of the Federal Open Market Committee and interpretations of the Board of Governors of the Federal Reserve System. Eligibility can be determined by reviewing documentary evidence detailing the nature of the transaction underlying the credit extended. This evidence may be correspondence, title documents or document transmittal letters which provide sufficient detail to judge eligibility according to established criteria. Details provided should cover:
        • Value of merchandise.
        • Description of merchandise.
        • Origin and destination of shipment.
        • Date of shipment.
        • Certification that the merchandise is not being financed elsewhere.
    d. Ensure that all of the bank's own acceptances discounted that are not rediscounted, whether eligible or ineligible, are booked as loans and thus subject to the loan limitations imposed by state law.
    e. Determine if state law imposes loan limitations on eligible acceptances of other banks purchased.
    f. Review acceptance participation agreements to determine if the purchaser has recourse to the bank in the event of default by the account party, in which case the liability would be considered a borrowing. Such borrowings may be subject to limitations on indebtedness of member banks imposed by state law.
    g. Determine acceptances issued on behalf of an affiliate which constitute extensions of credit under section 23A of the Federal Reserve Act.
16. Perform appropriate procedural steps in the Concentration of Credits section.
17. Discuss with appropriate officer and prepare summaries in appropriate report form of:
    a. Violations of laws and regulations.
    b. Acceptances not supported by current and complete financial information.
    c. Acceptances on which collateral documentation is deficient.
    d. Concentrations of credit.
    e. Criticized loans.
    f. Inadequately collateralized acceptances, if applicable.
    g. Banker's acceptances created for major shareholders, employees, officers, directors and related interests.
    h. Banker's acceptances which, for any other reason, are questionable as to quality and ultimate collection.
18. Evaluate the bank with respect to:
    a. The adequacy of written policies relating to banker's acceptances.
    b. The manner in which bank officers are operating in conformance with established policy.
    c. Adverse trends within the banker's acceptance department.
    d. The accuracy and completeness of the schedules obtained.
    e. Internal control deficiencies or exceptions.
    f. Recommended corrective action when policies, practices or procedures are deficient.
    g. The quality of departmental management.
    h. Other matters of significance.
19. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures for creating and servicing banker's acceptances. The bank's system should be documented in a complete and concise manner and include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written banker's acceptance policies that:
   a. Establish procedures for reviewing banker's acceptance applications?
   b. Define qualified customers?
   c. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
2. Are banker's acceptance policies reviewed at least annually to determine if they are compatible with changing market conditions?

RECORDS

3. Is the preparation and posting of subsidiary banker's acceptance records performed or reviewed by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?
4. Are the subsidiary banker's acceptance records balanced daily with the appropriate general ledger accounts and reconciling items adequately investigated by persons who do not normally handle acceptances and post records?
5. Are acceptance delinquencies prepared for and reviewed by management on a timely basis?
6. Are inquiries about acceptance balances received and investigated by persons who do not normally handle settlements or post records?
7. Are bookkeeping adjustments checked and approved by an appropriate officer?
8. Is a daily record maintained summarizing acceptance transactions details, i.e., bankers acceptances created, payments received and fees collected, to support applicable general ledger account entries?
9. Are acceptances of other banks that have been purchased in the open market segregated on the bank's records from the bank's own acceptances created?
10. Are prepayments (anticipations) on outstanding banker's acceptances netted against the appropriate asset account "Customer Liability for Acceptances" (or loans and discounts, depending upon whether or not the bank has discounted its own acceptance), and do they continue to be shown as a liability "Bank's Liability on Acceptances"?
11. Are banker's acceptance record copies and liability ledger trial balances prepared and reconciled monthly with control accounts by employees who do not process or record acceptance transactions?

FEES

12. Is the preparation and posting of fees and discounts performed or reviewed by persons who do not also:
    a. Issue official checks or drafts?
    b. Handle cash?
13. Are any independent fee and discount computations made and compared or adequately tested to initial fee and discount records by persons who do not also:
    a. Issue official checks or drafts?
    b. Handle cash?

COLLATERAL

See International—Loans and Current Account Advances section.

OTHER

14. Are acceptance record copies, own acceptances discounted (purchased), and acceptances of other banks purchased safeguarded during banking hours and locked in the vault overnight?

15. Are blank (pre-signed) customer drafts properly safeguarded?
16. Are any acceptance fee rebates approved by an officer?
17. Does the bank have an internal review system that:
    a. Re-examines collateral and supporting documentation held for negotiability and proper assignment?
    b. Test checks the values assigned to collateral at frequent intervals?
    c. Determines that lending officers are periodically advised of maturing banker's acceptances or acceptance lines.
18. Does the bank's acceptance filing system provide for the identification of each acceptance, e.g., by consecutive numbering and applicable letter of credit, to provide a proper audit trail?

CONCLUSION

19. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
20. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

U.S. banks and their overseas branches maintain interest-bearing time deposits, known as ''due from banks—time,'' with foreign banks and overseas branches of U.S. banks. These assets may also be referred to as placements, placings, interbank placements (deposits), call money, or redeposits. Due from banks—time deposits have maturities ranging from one day to several months or years. Certain examination procedures, internal control considerations, and verification procedures in the domestic due from banks section (section 2010) are relevant to international due from banks—time. However, the specialized nature of foreign deposits necessitates additional examination procedures.

Constraints are placed on the amount member banks may deposit with domestic depository institutions. A member bank may not keep on deposit with any depository institution not having access to the Federal Reserve discount window more than 10 percent of its paid-in and unimpaired capital and surplus funds. State member banks may keep on deposit with foreign banks an amount exceeding that 10 percent limitation.

Due from banks—time deposit activities became important with the growth of the Eurodollar market. The bulk of due from banks—time deposits now consists of Eurodollars with smaller amounts in other Eurocurrencies. Other Eurocurrency time deposits are placed in substantially the same manner as Eurodollar deposits, but may be subject to differing exchange control regulations depending on the location of the office making the deposit.

Eurodollar deposits are sometimes linked with foreign-exchange transactions. As a result, the Eurocurrency deposit trader will frequently work closely with the foreign-exchange trader when making the deposit decision. Foreign-exchange brokers may act as intermediaries if warranted by market conditions, local customers, the size of the bank, or other factors.

Due from banks—time deposits are treated as deposits in the Report of Condition, but contain the same credit and country risks as loans or extensions of credit. Consequently, a prudently managed bank should place deposits only with other sound and well-managed banks. The deposit traders should be provided with a list of approved banks with which funds can be deposited up to specific limits. Due from banks—time deposits differ from other types of credit extensions because they often represent deposits of relatively short maturity, which normally receive first priority on repayment in case of insolvency. Nevertheless, as credit and transfer risk exists, exposure limits are to be established by credit officers and not by foreign-exchange or deposit traders. These limits must be reviewed regularly by credit officers, particularly during periods of money market uncertainty or rapidly changing economic and political conditions. Incoming confirmations of transactions from depository institutions must be carefully verified against bank records to protect against fraud and error. Similarly, a systematic follow-up on nonreceipt of incoming confirmations should be closely monitored.

International—Due from Banks—Time
Examination Objectives
Effective date May 1996

Section 7070.2

1. To determine if the policies, practices, procedures, and internal controls for due from banks—time (interbank placements and call money) are adequate.
2. To determine if bank officers and employees are operating in conformance with the established guidelines.
3. To determine that all due from banks—time accounts are reasonably stated and represent funds on deposit with other banks.
4. To determine whether the bank evaluates the credit quality of banks with which time accounts are maintained.
5. To determine the scope and adequacy of the internal and external audit function as it applies to international due from banks—time.
6. To determine compliance with laws and regulations.
7. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws, rulings, or regulations have been cited.

1. If selected for implementation, complete or update the Due from Banks—Time (placement and call money) section of the Internal Control Questionnaire.
2. Determine the scope of the examination based on the evaluation of internal controls and the work performed by internal and external auditors.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
4. Obtain a trial balance of the customer liability records pertaining to due from banks—time by currency and maturity and:
   a. Reconcile balance to department controls and general ledger.
   b. Review reconciling items for reasonableness.
5. Determine those due from banks—time deposits that are unconfirmed as of examination date and:
   - Determine why incoming matching confirmations are lacking.
   - Review the extent of follow-up procedures.
6. Using an appropriate technique, select deposit customers for examination.
7. Prepare credit line cards on the customers selected for review to include the following:
   a. Name of bank and location.
   b. Customer's aggregate due from bank-time liability.
   c. For each due from bank—time deposit placement comprising the customer's total exposure to the bank, record the following information:
      - Amount.
      - Currency.
      - Inception date.
      - Value date.
      - Maturity date.
      - Interest rate.
8. Determine whether selected customers are:
   a. Affiliates of the bank or other banks.
   b. Banks and not finance companies or commercial borrowers.
9. Obtain and review the following information, if applicable:
   a. Matured and unpaid due from banks—time deposits.
   b. Miscellaneous loan debit and credit suspense accounts.
   c. Interagency Country Exposure Review Committee determinations.
   d. Due from banks—time deposit placements that are considered problem assets by management.
   e. Specific guidelines stated in bank policy relating to due from banks—time.
   f. A current listing of due from banks—time approved customer lines.
   g. The current interest rate structure.
   h. Any useful information resulting from the review of the minutes of the Loan and Discount Committee or any similar committee.
   i. Reports furnished to the Board of Directors.
   j. Due from banks—time deposit placements that were criticized during the previous examination.
   k. A listing of due from banks—time deposits that were previously charged-off.
10. Transcribe or compare information from the above schedules to credit line cards where appropriate, and indicate any cancelled bank lines.
11. Prepare credit line cards for any due from bank—time not in the sample which, based on information derived from the above schedules, requires an in-depth review.
12. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts, and loan areas and decide who will review the borrowing relationship. Pass or retain completed credit line cards.
13. Obtain credit files for all borrowers for whom credit line cards were prepared and complete credit line cards where appropriate. To analyze due from banks—time, perform the following procedures:
    a. Analyze balance sheet and profit and loss figures as shown in current and preceding financial statements, and determine

the existence of any favorable or adverse trends.

b. Relate items or groups of items in the current financial statements to other items or groups of items set forth in the statements, and determine the existence of any favorable or adverse ratios.
c. Review components of the balance sheet as shown in the current financial statements, and determine the reasonableness of each item as it relates to the customer's total financial structure.
d. Review supporting information for the major balance sheet items and the techniques used in consolidation, and determine the primary sources of repayment and evaluate their adequacy.
e. Compare each bank's balance sheet, profit and loss items and ratios with those of comparable banks in the same country to help identify banks which may be overextended.
f. Review compliance with provisions of due from banks—time deposit agreements.
g. Review digest of officers' memoranda, mercantile reports, credit checks and correspondence to determine the existence of any problems which might deter the contractual liquidation program.
h. Compare interest rate(s) charged to the interest rate schedule(s), and determine that the terms are within established guidelines.
i. Compare the amount of due from banks—time deposits with:
   - Lending officer's authority.
   - Depositor's limit established by the bank.
j. Detail the major owners of the bank and whether there is any support by the government.
k. Ascertain compliance with established bank policy.

14. For banks in the sample, check the customer central liability reporting system for any other indebtedness.
15. Transcribe significant liability and other information on officers, principals and affiliates of banks contained in the sample. Cross-reference line cards to banks (borrowers), where appropriate.
16. Determine compliance with state laws and regulations pertaining to due from banks—time.
17. Determine the existence of any concentration of time deposits with other banks. Include due from banks—demand (nostro), time deposits and any call money in computation. For concentrations exceeding 25 percent of the bank's capital structure, forward information to examiners assigned "Concentrations of Credit" for possible inclusion in the report of examination.
18. Discuss with appropriate officer(s) and prepare summaries in appropriate report form of:
    a. Matured and unpaid due from banks—time deposits.
    b. Violations of laws and regulations.
    c. Due from banks—time deposits not supported by current and complete financial information.
    d. Due from banks—time deposits on which documentation is deficient.
    e. Concentrations.
    f. Criticized credits (portions applicable to due from banks—time deposits).
    g. Due from banks—time deposits which, for any other reason, are questionable as to quality and ultimate repayment.
    h. Other matters regarding the condition of the department.
19. Evaluate the bank with respect to:
    a. The adequacy of written policies relating to due from banks—time.
    b. The manner in which bank officers are operating in conformance with established policy.
    c. Adverse trends within the due from banks—time department.
    d. The accuracy and completeness of the schedules.
    e. Internal control deficiencies or exceptions.
    f. Recommended corrective action when policies, practices or procedures are found to be deficient.
    g. The quality of departmental management.
    h. Other matters of significance.
20. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures regarding due from banks—time. The bank's system should be documented in a complete and concise manner and include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written policies for international due from banks—time that:
   a. Establish maximum limits of the aggregate amount of due from bank—time deposits for each:
      - The bank?
      - The currency of deposit?
      - The country of deposit?
   b. Restrict due from bank—time deposits to only those customers for whom lines have been established?
   c. Establish definite procedures for:
      - Balancing of accounts?
      - Holdover deals?
      - Rendering of reports to management, external auditors and regulating agencies?
      - Accounting cutoff deadlines?
      - Handling of interest?

CERTIFICATES OF DEPOSIT

2. Are bank issued certificates of deposits safeguarded as other negotiable investment instruments?
3. Are safekeeping receipts for certificates of deposits issued, but held by others, checked to the original purchase order for accuracy?

DEALING ROOM INSTRUCTIONS

(Although dealing room and instructions functions must be separate, often foreign exchange and due from bank—time activities relating to those functions are combined.)

4. Are dealer slips and contract/confirmation sets relating to due from banks—time numbered sequentially and checked periodically?
5. Is a positions clerk present in the dealing room to maintain dealers' memoranda records of due from bank—time deposits?
6. Is due from banks—time "instructions" (operations) organizationally and physically separate from the foreign exchange dealers?

*7. Do good communications appear to exist between the dealing room and instructions to assure:
   a. An effective working relationship with operations and management to ensure adequate control and management information?
   b. Coordination with operations regarding correct delivery/settlement instructions?

*8. Does operations maintain all official accounting records relating to due from banks—time?

*9. Does operations:
   a. Balance official records against dealing room memoranda records as scheduled by management?
   b. Check confirmations for errors?
   c. Receive, review and control dealer's slips?
   d. Handle all payments and receipts?

*10. Are confirmations compared to the general ledger entries for accuracy?

CONFIRMATIONS

*11. Does operations monitor follow-up on non-receipt of incoming confirmations?

*12. Are outgoing and incoming confirmations ever handled by dealers who initiate due from bank—time transactions?

*13. Does the bank check that there are no confirmation deals dated:
   a. Prior to the bank's own due from bank—time deal dates?
   b. After the bank's own due from bank—time deal dates?

TESTING ARRANGEMENTS

(See the Wire Transfer section.)

SIGNATURE BOOKS

*14. Are customer signature books updated with regard to those with whom regular business is transacted?

*15. Does the bank check signatures on incoming confirmations for authenticity? (Many banks do not check signatures on incoming confirmations.)

*16. Does the bank check signatures for deals with non-bank customers?

*17. Are banks that do not sign confirmations asked to confirm such practice in writing over an authorized signature?

ACCOUNT RECORDS

*18. Are subsidiary records reconciled with the general ledger accounts and reconciling items adequately investigated by persons who do not post transactions to such records?

19. Is a due from foreign bank—time deposit trial balance prepared on a periodic basis (if so, indicate frequency _______)?

20. Is a daily reconcilement made of due from bank—time deposit controls to the general ledger?

21. Are reconciliations reviewed by an officer independent of the reconciliation?

OTHER

22. Are individual interest computations checked or adequately tested by persons independent of those functions?

23. Are accrual balances for due from banks—time verified periodically by an authorized official (if so, indicate frequency _______)?

24. Do all internal entries require the approval of appropriate officials?

CONCLUSION

25. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

26. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

INTRODUCTION

Letters of credit are the most widely used instrument to finance foreign transactions. The two major types of letters of credit are the commercial documentary letter of credit and the standby letter of credit.

COMMERCIAL DOCUMENTARY LETTERS OF CREDIT

This type of letter of credit is used most commonly to finance a commercial contract for the shipment of goods from seller to buyer. A commercial documentary letter of credit is a letter addressed by a bank (issuing bank) on behalf of its customer, a buyer of merchandise (account party), to a seller (beneficiary) authorizing the seller to draw drafts up to a stipulated amount under specified terms. The beneficiary will be paid when the terms of the letter of credit are met and the required documents are submitted to the paying bank.

Generally, the issuance of letters of credit is governed by article 5 of the Uniform Commercial Code (UCC). However, if the credit is issued under New York law, the credit will be governed instead by the Uniform Customs and Practice for Documentary Credits (UCP). The parties may also stipulate that the UCP rather than the UCC applies. Letters of credit may also be governed by foreign law. Generally, letters of credit are—

- signed and in writing,
- in favor of a definite beneficiary,
- for a specific amount of money, and
- in a form clearly stating how payment to the beneficiary is to be made and under what conditions.

In addition, they are issued with a definite expiration date.

Commercial letters of credit are issued in either irrevocable or revocable form. Once the beneficiary receives an irrevocable letter of credit, it cannot be canceled or amended without the beneficiary's consent. Conversely, a revocable letter of credit can be canceled or amended by the issuing bank at any time without notice to or consent from the customer or the beneficiary.

An irrevocable letter of credit constitutes a definite commitment by the issuing bank to pay, provided the beneficiary complies with the letter's terms and conditions. In contrast, the revocable credit is not truly a bank credit but serves as a device that provides the buyer and seller with a means of settling payments. Since a revocable credit can be canceled or changed without notice, the beneficiary should not rely on the credit but rather on the willingness and ability of the buyer to meet the terms of the underlying contract.

The letter of credit may be sent to the beneficiary directly by the issuing bank or through the issuing bank's correspondent (advising bank) located in the same place as the beneficiary. The advising bank gives notice of the issuance of a letter of credit without assuming any obligation to honor demands for payment. Advised letters of credit will bear a notation by the advising bank that it makes ‘‘no engagement’’ or words to that effect. An irrevocable advised letter of credit is, therefore, an undertaking to pay by the issuing bank, but not by the advising bank.

Some beneficiaries (sellers), particularly those not familiar with the issuing bank, request the buyer to have the irrevocable credit issued in the buyer's country and ‘‘confirmed’’ by a bank in the seller's country. Confirmed letters of credit are evidenced by the confirming bank's notation: ‘‘We undertake that all drafts drawn . . . will be honored by us’’ or similar words. The beneficiary of a confirmed credit has a definite commitment to pay from a bank in his or her country and need not be concerned with the willingness or ability of the issuing bank to pay. An advising bank may add its confirmation and be designated in the letter as the paying bank.

Payment terms of a letter of credit usually vary from sight to 180 days, although other terms are sometimes used. The letter will specify on which bank drafts are to be drawn. If the draft is drawn at sight, the bank will effect payment upon presentation of the draft, provided the terms of the credit have been met. If the draft is drawn on a time basis, the bank will accept the draft (by stamping ‘‘Accepted’’ on the face of the draft), which then can be held by the seller or the bank until maturity. Alternatively, the accepted draft can be sold or discounted.

(See section 7060, ''International—Banker's Acceptances.'')

Certain categories of commercial letters of credit, such as back-to-back and red clause credits, contain an element of risk, and banks should exercise caution in their negotiation. Similarly, deferred-payment letters of credit, which become direct assets and liabilities of a bank after presentation and receipt of the beneficiary's documents, involve greater potential risk when coupled with the length of time the credit is outstanding.

A transferable letter of credit enables the original beneficiary to transfer the rights of payment to one or more beneficiaries. Frequently, the beneficiary is a middleman who does not own the goods at the time the letter of credit is issued. Thus, the beneficiary may seek to use the letter of credit to finance the acquisition of the goods. Under the UCP, a transferable letter of credit may be transferred only once unless otherwise stated.

A revolving letter of credit allows for monthly shipments with payments being either cumulative or noncumulative. In the case of cumulative credits, undrawn amounts carry over to future periods. However, most letters of credit are nonrevolving and are valid for one transaction. Since the maximum exposure under an irrevocable revolving credit can be large, most revolving credits are issued in revocable form.

Documentation is of paramount importance in all letter of credit transactions. The bank is required to examine all documents with care to determine that they conform to all of the terms and conditions of the letter of credit. Many letters of credit are part of continuous transactions, evolving from letters of credit to sight drafts or acceptances or to notes and advances covered by trust receipts or warehouse receipts. Ultimate repayment often depends on the eventual sale of the goods involved. Thus, the proper handling and accuracy of the documents required under the letter of credit is of primary concern.

STANDBY LETTERS OF CREDIT

A standby letter of credit guarantees payment to the beneficiary by the issuing bank in the event of default or nonperformance by the account party (the bank's customer). Although a standby letter of credit may arise from a commercial transaction, it is not linked directly to the shipment of goods from seller to buyer. It may cover performance of a construction contract, serve as an assurance to a bank that the seller will honor his or her obligations under warranties, or relate to the performance of a purely monetary obligation, for example, when the credit is used to guarantee payment of commercial paper at maturity.

Under all letters of credit, the banker expects the customer to be financially able to meet his or her commitments. A banker's payment under a commercial credit for the customer's account is usually reimbursed immediately by the customer and does not become a loan. However, the bank makes payment on a standby letter of credit only when the customer, having defaulted on his or her primary obligation, is unable to reimburse it.

A standby letter of credit transaction involves greater potential risk for the issuing bank than a commercial documentary letter of credit. Unless the transaction is fully secured, the issuer of a standby letter of credit retains nothing of value to protect against loss, whereas a commercial documentary letter of credit provides the bank with title to the goods being shipped. To reduce the risk of a standby letter of credit, the issuing bank's credit analysis of the account party should be equivalent to the analysis of a borrower in an ordinary loan situation.

The standby letter of credit transactions of state member banks are subject to the legal restrictions of Regulation H and section 23A of the Federal Reserve Act. For reporting purposes, standby letters of credit are shown as contingent liabilities in the issuer's Report of Condition.

Under the revised capital/risk assets guidelines, banks now must allocate capital against standby letters of credit. See the capital adequacy guidelines of November 1995 for information concerning capital allocation requirements against standby letters of credit.

ANTI-BOYCOTT REGULATIONS

The Export Administration Act of 1973 prohibits banks from taking or knowingly agreeing to take actions that support any boycott against a country friendly to the United States. Under anti-boycott regulations (which are issued by the Department of Commerce and enforced by the

Office of Anti-Boycott Compliance), U.S. banks are required to report letters of credit they receive that include illegal boycott terms or conditions and should establish an ongoing program to review all letters of credit. These regulations apply to both domestic and overseas branches of all U.S. banks.

The anti-boycott provisions prohibit banks from opening, negotiating, confirming, or paying international letters of credit that contain illegal terms or conditions. The improper language is most often seen in documentary letters of credit, sight reimbursements, and pass-on letters of credit, but may also appear in drafts and wire payments. Often, a bank's customer may try to add improper language orally rather than in writing. Boycott language includes clauses or requirements such as—

- certification that the goods are not of a particular origin, such as Israeli or South African;
- certification that any supplier or provider of services does not appear on the Arab blacklist;
- the condition, "Do not negotiate with blacklisted banks," or words to that effect;
- a request not to ship goods on an Israeli carrier or on a vessel or carrier that calls at Israel en route to a boycotting country; and
- a request for a certificate stating the origin of the goods or the destination of the goods.

1. To determine if objectives, policies, practices, procedures, and internal controls for letters of credit are adequate.
2. To determine whether bank officers are operating in conformance with established guidelines.
3. To determine the scope and adequacy of the audit function.
4. To evaluate the portfolio for documentation and collateral sufficiency, credit quality, and collectibility.
5. To determine compliance with applicable laws and regulations.
6. To recommend corrective action when objectives, policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations are noted.

1. If selected for implementation, complete or update the Letters of Credit section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal and external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
4. Obtain a trial balance of the customer liability records and:
   a. Reconcile balances to department controls and the general ledger.
   b. Review reconciling items for reasonableness.
5. Using an appropriate technique, select customers for examination.
6. Prepare examiners' credit line cards for each customer selected to include:
   a. Total line available for letters of credit.
   b. Total outstanding letters of credit.
      - Undrawn amount.
      - Date of issuance.
      - Expiration date of the credit.
      - Name of the beneficiary.
      - Tenor of the drafts to be drawn.
      - Purpose for the credit.
      - Issued or confirmed.
      - Revocable or irrevocable.
      - Negotiable or non-negotiable.
      - Revolving.
        — Cumulative or noncumulative.
      - Transferable.
      - Assignable.
      - Amendments.
      - Issued on behalf of domestic banks.
      - Application (with official approval) is on file and in agreement with letter of credit terms.
      - Bank's copy is initialed by the officer who signed the original letter of credit.
7. Obtain the following information if it is applicable to the letter of credit department. Such information may necessitate inclusion of additional customers in the credit review.
   a. Delinquencies.
   b. Participations purchased and sold since the preceding examination (including syndicate participations).
   c. Loan commitments and other contingent liabilities.
   d. Letters of credit issued (or confirmed) for major shareholders, officers, directors and their related interests.
   e. Letters of credit issued (or confirmed) for employees, officers and directors of other banks.
   f. Miscellaneous loan debit and credit suspense accounts.
   g. Criticized shared national credits (applicable foreign credits).
   h. Interagency Country Exposure Review Committee determinations.
   i. Letters of credit considered problems by management.
   j. Information on directors, executive officers, principal shareholders and their interests.
   k. Specific guidelines in the lending policies.
   l. Each officer's current lending authority.
   m. Current letter of credit commission and fee structure.
   n. Any useful information obtained from the review of the minutes of the Loan and Discount Committee or any similar committee.
   o. Reports furnished to the Loan and Discount Committee or any similar committee.
   p. Reports furnished to the board of directors.
   q. Loans criticized during the previous examination.
8. Review the information received and perform the following for:
   a. Participations purchased and sold (including syndicate participations).
      - Test participation certificates and records and determine that the parties share in the risks and contractual payments according to the agreement.

- Determine that the books and records of the bank properly show the bank's liability.
- Investigate any participations sold immediately prior to the date of examination to determine if any were sold to avoid possible criticism during the examination.

b. Loan commitments and other contingent liabilities:
- Analyze the commitment or contingent liability if the borrower has been advised of the commitment and the combined amounts of the current loan balance (if any) and the commitment or other contingent liability exceeds the cutoff.

c. Letters of credit issued (or confirmed) for officers, directors and their interests:
- Investigate any circumstances which indicate preferential treatment.

d. Letters of credit issued (or confirmed) for officers and directors of other banks.
- Investigate any circumstances which indicate preferential treatment.

e. Miscellaneous loan debit and credit suspense accounts relating to letters or credit.
- Determine liability to the bank on drafts paid under letters of credit for work which the bank has not been reimbursed by the customer.
- Investigate any large or old items.

f. Shared national credits:
- Compare the schedule of letters of credit included in the program to the bank's reports of unexpired letters of credit.
- For each letter of credit so identified, transcribe appropriate information to line cards. No further examination procedures are necessary in this area.

g. Interagency Country Exposure Review Committee credits:
- Identify any credits that were selected for review that are criticized for transfer risk reasons by the Interagency Country Exposure Review Committee.

h. Letters of credit criticized during the previous examination:
- Determine disposition of letters of credit so criticized by transcribing:
  — Current balance and payment status, or
  — Date the letter of credit was drawn down (refinanced), paid, expired or cancelled, and the source of repayment.

9. Transcribe or compare information from the above schedules to credit line cards, where appropriate, and indicate any past due status relating to letters of credit.
10. Prepare credit line cards for any letter of credit not in the sample which, based on information derived from the above schedules, requires an in-depth review.
11. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts, and loan areas and decide who will review the borrowing relationship. Pass or retain examination credit line cards.
12. Obtain credit files for all bank customers for whom credit line cards were prepared and complete credit line cards, where appropriate. To analyze the letters of credit, perform the following procedures:
    a. Analyze balance sheet and profit and loss items as shown in current and preceding financial statements, and determine the existence of any favorable or adverse trends.
    b. Relate items or groups of items in the current financial statements to other items or groups of items set forth in the statements, and determine the existence of any favorable or adverse ratios.
    c. Review components of the balance sheet as shown in the current financial statements, and determine the reasonableness of each item as it relates to the total financial structure.
    d. Review supporting information for the major balance sheet items and the techniques used in consolidation, and determine the primary sources of repayment and evaluate their adequacy.
    e. Review compliance with provisions of letter of credit agreements.
    f. Review digest of officers' memoranda, mercantile reports, credit checkings and correspondence to determine the existence of any problems which might deter the contractual liquidation program.
    g. Relate any collateral values, including margin and cash collateral deposits, to outstanding letter of credit debt.
    h. Compare fees charged to the fee schedule(s), and determine that terms are within established guidelines.

i. Compare the amount of letters of credit outstanding with the lending officer's authority.
j. Analyze any secondary support afforded by guarantors.
k. Ascertain compliance with the bank's established commercial loan policy.
l. Analyze the following specific types of letters of credit (when applicable) to determine if:
   - For Red Clause Letters of Credit (Packing Credits):
     — Clean advance or anticipatory drawing finance to the beneficiary (exporter or agent) is authorized under the letter of credit.
     — The beneficiary undertakes to deliver within the expiration date the shipping documents called for in the letter of credit.
     — The foreign bank makes advances to the beneficiary and is paid by drawing its own draft on the opening bank or the beneficiary is authorized to draw its draft on the issuing bank, and the drafts received charged to the importer.
   - For Travelers' Letters of Credit:
     — A travelers' letter of credit authorizes the issuing bank's correspondent to negotiate drafts drawn by the beneficiary named in the credit up to a specified amount upon proper identification.
     — The customer is furnished with a list of the issuing bank's correspondents abroad.
     — The letter of credit is prepaid in full.
   - For Back-to-Back Letters of Credit:
     — The backing letter of credit is properly assigned as collateral to the bank issuing the letter of credit.
     — The terms of the letter of credit issued are identical to the backing credit except that:
       · The beneficiary and account party are different.
       · The amount may be less but not more than the backing credit.
       · The expiration date is reduced by sufficient time to allow completion of the transaction before the backing letter of credit expires.
     — The beneficiary of the backing letter of credit is a regular customer of the bank opening the second letter of credit.
   - For Standby Letters of Credit:
     — They represent undertakings to pay up to a specific amount upon presentation of a draft(s) and/or documents prior to a specified date.
     — They represent obligations to a beneficiary on part of the issuer to:
       · Repay money borrowed by or advanced to, or for the account party.
       · Make payment on account of any indebtedness undertaken by the account party. Make payment on account of default by the account party in the performance of an obligation, e.g., default on loans, performance of contracts, or relating to maritime liens.
   - For Deferred Payment Letters of Credit (trade-related):
     — The letter of credit calls for drawing of sight drafts with the provison that such drafts are not to be presented until a specified period after presentation and surrender of shipping documents to the bank.
     — The bank's liability for outstanding letters of credit calling for deferred payment is reflected as contingent liability until presentation of such documents.
     — The bank has received, approved and acknowledged receipt of the documents thereby becoming directly liable to pay the beneficiary at a determinable future date(s).
     — Payment will be made to the beneficiary in a specified number of months or quarterly, semiannually, annually, or beyond. (If the bank has advanced money to the beneficiary against the deferred payment letter of credit, with its proceeds assigned as collateral to repay the advance, the transaction should be treated as a loan rather than a deferred payment letter of credit).
   - For Clean Deferred Payment Letters of Credit:

- — Such deferred payment credits call for future payment against simple receipt without documents evidencing an underlying trade transaction.
- — Such letters of credit are shown as direct liabilities on the bank's records when drafts are presented by the beneficiary and received by the bank.

- For Authority to Purchase:
  - — The authority to purchase is with recourse to the drawer, without recourse to the drawer, or without recourse to the drawer but confirmed by the negotiating bank.
- For Agency for International Development (AID) Letters of Credit:
  - — The bank has an AID letter of commitment authorizing the transaction.
  - — The bank has checked to make sure that all documents, including those presented by the beneficiary, comply with the terms of both the letter of credit and the AID commitment.
  - — A letter of agreement between the bank and the foreign government exists whereby the bank has recourse should AID fail to reimburse the bank.
- For Commodity Credit Corporation (CCC) Letters of Credit:
  - — The bank has a CCC letter of commitment authorizing the bank under examination to issue letters of credit to beneficiaries supplying eligible commodities to foreign importers.
  - — In instances where the bank has issued standby letters of credit in favor of the CCC, the following requirements have been met:
    - At least 10 percent of the financed amount is confirmed, i.e., guaranteed by a U.S. bank for commercial credit risk. The total value of the credit is advised through a U.S. bank.
- For the Export-Import Bank (Eximbank) of the United States:
  - — The bank has an agency agreement from Eximbank stating:
    - Eximbank has entered into a line of credit with a foreign borrower.
    - The amount of the line.
    - The bank has been designated to issue the letter of credit(s).
    - Any payments made under an Eximbank approved letter of credit will be reimbursed by Eximbank.
  - — The bank has checked to make sure that all documents, including those presented by the beneficiary, comply with the terms of both the letter of credit and the Eximbank agreement.
- For Advised (Notified) Letters of Credit:
  - — The bank is only advising the beneficiary without responsibility on its part. (They should not be examined unless the bank has notified the letter of credit terms erroneously to the beneficiary, thus resulting in a possible liability for the bank.)
- For Other Types of Letters of Credit:
  - — Any of the following U.S. government agencies and international organizations reimburses the bank for issuing letters of credit on their behalf:
    - International Bank for Reconstruction and Development (World Bank)
    - Inter-American Development Bank
    - Overseas Private Investment Corporation

13. For loans in the sample, check central liability file on borrower(s) indebted above the cutoff or borrower(s) displaying credit weakness or suspected of having additional liability in other loan areas.
14. Transcribe significant liability and other information on officers, principals and affiliations of appropriate obligors contained in the sample. Cross-reference line cards to borrowers, where appropriate.
15. Determine compliance with section 208.8(d) of Regulation H regarding standby letters of credit by performing the following steps:
    a. Determine which letters of credit are standby letters of credit as defined by section 208.8(d)(1) of Regulation H.

b. Determine that the amount of standby letters of credit does not exceed the legal limitations on loans imposed by the state (including limitations to any one customer or on aggregate extensions of credit).
   - Combine standby letters of credit with any other nonexcepted loans to the account party by the issuing bank for the purpose of applying state loan limitations to any one customer.
   - A standby letter of credit is not subject to loan limitations imposed by state law in the following instances:
     - — Prior to or at the time of issuance of the credit, the issuing bank is paid an amount equal to the bank's maximum liability under the standby letter of credit.
     - — Prior to or at the time of issuance, the bank has set aside sufficient funds in a segregated, clearly earmarked deposit account to cover the bank's maximum liability under the standby letter of credit.

c. Determine for standby letters of credit which constitute extensions of credit under section 23A of the Federal Reserve Act when issued on behalf of an affiliate that:
   - The legal lending limits pertaining to loans to affiliates have not been exceeded.
   - Appropriate collateral requirements have been met.

d. Determine that the bank maintains adequate control and subsidiary records of its standby letters of credit in conformance with paragraphs (d)(2)(iii) and (d)(3) of section 208.8 of Regulation H.

e. Determine that the credit standing of the account party under any standby letter of credit is the subject of credit analysis equivalent to that applicable to a potential borrower in an ordinary loan situation.

f. Determine that the bank adequately discloses all outstanding standby letters of credit in its published financial statements pursuant to section 208.8(d)(3) of Regulation H.

16. Perform appropriate procedural steps in the Concentration of Credits section.

17. Discuss with appropriate officer(s) and prepare summaries in appropriate report form of:
    a. Letters of credit not supported by current and complete financial information.
    b. Letters of credit on which collateral documentation is deficient.
    c. Inadequately collateraled letters of credit.
    d. Criticized letters of credit.
    e. Concentrations of credit.
    f. Letters of credit issued in favor of major shareholders, employees, officers, directors and their interests.
    g. Letters of credit which, for any other reason, are questionable in quality.
    h. Violations of laws and regulations.
    i. Other matters regarding the condition of the letters of credit department.

18. Prepare and give to the examiner-in-charge a written evaluation of the letters of credit department with respect to:
    a. The adequacy of written policies relating to letters of credit.
    b. The manner in which bank officers are operating in conformance with established policies.
    c. Delinquencies relating to letters of credit, segregating those considered "A" paper.
    d. Adverse trends within the letter of credit department.
    e. The accuracy and completeness of the schedules obtained.
    f. Internal control deficiencies or exceptions.
    g. Recommended corrective action when policies, practices or procedures are deficient.
    h. The quality of departmental management.
    i. Other matters of significance.

19. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures for letters of credit issued and confirmed. The bank's system should be documented in a complete and concise manner and include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written letter of credit policies that:
   a. Establish procedures for reviewing letter of credit applications?
   b. Define qualified customers?
   c. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
2. Are letter of credit policies reviewed at least annually to determine if they are compatible with changing market conditions?

RECORDS

*3. Is the preparation and posting of subsidiary letter of credit records performed or reviewed by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

*4. Are the subsidiary letter of credit records (control totals) balanced daily with the appropriate general ledger accounts and reconciling items adequately investigated by persons who do not normally handle letters of credit and post records?

*5. Are delinquencies arising from the nonpayment of instruments relating to letters of credit prepared for and reviewed by management on a timely basis?

*6. Are inquiries regarding letter of credit balances received and investigated by persons who do not normally process documents, handle settlements or post records?

*7. Are bookkeeping adjustments checked and approved by an apropriate officer?

*8. Is a daily record maintained summarizing letter of credit transaction details, i.e., letters of credit issued, payments received, and commissions and fees collected, to support applicable general ledger account entries?

9. Are frequent letter of credit record copies and liability ledger trial balances prepared and reconciled monthly with control accounts by employees who do not process or record letter of credit transactions?

COMMISSIONS

*10. Is the preparation and posting of commission records performed or reviewed by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

11. Are any independent commission computations made and compared or adequately tested to initial commission records by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

DOCUMENTATION

12. Are terms, dates, weights, description of merchandise, etc. shown on invoices, shipping documents, delivery receipts and bills of lading scrutinized for differences with those detailed in the letters of credit instruments?
13. Are procedures in effect to determine if:
   a. The above documents are signed when required?
   b. All copies of letters of credit are initialed by the officer who signed the original letter of credit?
   c. All amendments to letters of credit are approved by an officer?

COLLATERAL

(See International—Loans and Current Account Advances section.)

DEFERRED PAYMENT LETTERS OF CREDIT

*14. Are deferred payment letters of credit:
   a. Recorded as direct liabilities of the bank after it acknowledges receipt of the beneficiary's documents?
   b. Included in ''Other Assets'' and ''Other Liabilities'' in the call report?

STANDBY LETTERS OF CREDIT

*15. Are standby letters of credit segregated or readily identifiable from other types of letters of credit and/or guarantees?

OTHER

16. Are outstanding letter of credit record copies and unissued forms safeguarded during banking hours and locked in the vault overnight?

*17. Are advised letters of credit recorded as memoranda accounts separate from letters of credit issued or confirmed by the bank?

18. Are letters of credit which have been issued with reliance upon a domestic bank, whether on behalf of, at the request of, or under an agency agreement with the domestic bank, recorded as contingent liabilities under the name of that domestic bank?

19. Are any commission rebates approved by an officer?

20. Does the bank have an internal review system that:
   a. Re-examines collateral items for negotiability and proper assignment?
   b. Test check values assigned to collateral when the letter of credit is issued or confirmed and at frequent intervals thereafter?
   c. Determines that customer payments of letters of credit issued are promptly posted?
   d. Determines all delinquencies arising from the non-payment of instruments relating to letters of credit?

21. Are all letters of credit recorded and assigned consecutive numbers?

22. Are lending officers frequently informed of maturing letters of credit and letter of credit lines?

CONCLUSION

23. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

24. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

State member banks may not issue guarantees and sureties except for those that may be incidental or usual in conducting banking business, such as when a bank has a substantial interest in the performance of the transaction involved or has a segregated deposit sufficient in amount to cover its total potential liability. A state member bank also may guarantee or endorse notes or other obligations sold by the bank for its own account. The amount of the obligations covered by the guaranty or endorsement is to be recorded as a liability on the bank's records. These liabilities are included in computing the aggregate indebtedness of the bank, which may be subject to limitations imposed by state law. Furthermore, a state member bank is permitted to guarantee the deposits and liabilities of its Edge Act and agreement corporations and of its corporate instrumentalities in foreign countries.

A foreign branch of a member bank may engage in certain activities under Regulation K (12 CFR 211) in addition to its general banking powers to the extent that they are consistent with its charter. Those additional activities include guaranteeing a customer's debts or agreeing to make payment on the occurrence of readily ascertainable events, including, but not limited to, nonpayment of taxes, rentals, customs duties, the cost of transportation and loss, or the nonconformance of shipping documents. The guarantee or agreement must specify maximum monetary liability. The liabilities outstanding are subject to loan limitations on any one customer imposed by state law.

A common example of a guarantee is a shipside bond. Frequently, in an international sale of goods, the merchandise arrives at the importer's (buyer's) port before the arrival of correct and complete bills of lading. In these instances, it is customary for the importer (buyer) to obtain immediate possession of the goods by providing the shipping company with a bank guarantee, often called a shipside bond, that holds the shipping company blameless for damage resulting from release of the goods without proper or complete documents. Usually, the bank's guarantee relies on a counter-guarantee issued to the bank by the importer.

All types of guarantees issued are to be recorded as contingent liabilities by the bank. Usually, the party for whom the guarantee was issued will reimburse the bank should it be required to pay under the guarantee; however, in certain situations, some other designated party may reimburse the bank. That other party may be designated in the guarantee agreement with the bank or in the guarantee instrument itself. The bank may also be reimbursed from segregated deposits held, from pledged collateral, or by a counter-guarantor. Letters of credit, as distinguished from guarantees, are discussed in section 7080, "International—Letters of Credit."

International—Guarantees Issued
Examination Objectives
Effective date May 1996

Section 7090.2

1. To determine if policies, practices, procedures, and internal controls for guarantees issued are adequate.
2. To determine if bank officers are operating in conformance with established guidelines.
3. To evaluate the portfolio of guarantees for credit quality, collectibility, and collateral sufficiency.
4. To determine the scope and adequacy of the audit function as it applies to guarantees.
5. To determine compliance with applicable laws and regulations.
6. To recommend corrective action when objectives, policies, practices, procedures, or internal controls are deficient and when violations of laws and regulations have been cited.

1. If selected for implementation, complete or update the Guarantees Issued section of the Internal Control Questionnaire.
2. Determine the scope of the examination based upon the evaluation of internal controls and the work performed by internal and external auditors.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
4. Obtain a trial balance of the customer (account party) liability records and:
   a. Reconcile balances to department controls and the general ledger.
   b. Review reconciling items for reasonableness.
5. Using an appropriate technique, select guarantee account parties for examination.
6. Prepare credit line cards to include:
   a. Total line available for guarantees.
   b. Total outstanding guarantees.
7. Obtain the following information if it is applicable to the guarantees issued area:
   a. Loan commitments and contingent liabilities.
   b. Miscellaneous loan debit and credit suspense accounts.
   c. Criticized shared national credits.
   d. Interagency Country Exposure Review Committee determinations.
   e. Loans considered "problem loans" by management.
   f. Specific guidelines in the lending policy.
   g. Each officer's current lending authority.
   h. Any useful information resulting from the review of the minutes of the Loan and Discount Committee or any similar committee.
   i. Reports furnished to the Loan and Discount Committee or any similar committee.
   j. Reports furnished to the board of directors.
   k. Loans criticized during the previous examination.
8. Review the information received and perform the following for:
   a. Miscellaneous loan debit and credit suspense accounts:
      - Determine any liability to the bank resulting from guarantees paid by the bank for which it has not been reimbursed by an account party.
      - Discuss with management any large or old items.
      - Perform additional procedures as considered appropriate.
   b. Shared national credits:
      - Compare the schedule of guarantees issued included in the program to the bank's reports of unexpired guarantees.
      - For each guarantee so identified, transcribe appropriate information to line cards. No further examination procedures are necessary for these items.
   c. Interagency Country Exposure Review Committee Credits:
      - Identify any guarantees that were selected for review that are criticized for transfer risk reason by the Interagency Country Exposure Review Committee.
9. Transcribe or compare information from the above schedules to credit line cards, where appropriate, and indicate any past due status.
10. Prepare credit line cards for any guarantee not in the sample which, based on information derived from the above schedules, requires an in-depth review.
11. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts, loans and current account advances, due from foreign banks—time, and other loan areas and decide who will review the borrowing relationship. Pass on or retain completed credit line cards.
12. Obtain credit files for all customers (account parties) for whom credit line cards were prepared and complete credit line cards, where appropriate. To analyze the guarantees, perform the following procedures:
    a. Analyze balance sheet and profit and loss figures as shown in current and preced-

ing financial statements, and determine the existence of any favorable or adverse trends.
   b. Relate items or groups of items in the current financial statements to other items or groups of items set forth in the statements, and determine the existence of any favorable or adverse ratios.
   c. Review components of the balance sheet as reflected in the current financial statements, and determine the reasonableness of each item as it relates to the total financial structure.
   d. Review supporting information for the major balance sheet items and the techniques used in consolidation. Determine the primary sources of repayment and evaluate the adequacy of those sources.
   e. Determine compliance with the provisions of guarantee agreements.
   f. Review digest of officers' memoranda, mercantile reports, credit checkings and correspondence to determine the existence of any problems which might deter the contractual liquidation program.
   g. Relate collateral values, if any, to outstanding guarantee.
   h. Compare fees charged to the bank's fee schedule and determine that the terms are within established guidelines.
   i. Compare the original amount of the guarantee with the lending officer's authority.
   j. Analyze support afforded by counterguarantors.
   k. Ascertain compliance with the bank's established guarantee issued policy.
13. For guarantees issued in the sample, check central liability file on borrower(s) indebted above the cutoff or borrower(s) displaying credit weakness or suspected of having additional liability in loan areas.
14. Transcribe significant liability and other information on officers, principals and affiliations of appropriate account parties contained in the sample. Cross-reference line cards to borrowers, where appropriate.
15. Determine compliance with state laws and regulations pertaining to guarantees issued by performing the following steps:
   a. Determine that the obligations covered by such guarantees or endorsements are shown as contingent liabilities on the records and in the reports of condition of the bank and that such liabilities are included in computing the aggregate indebtedness of the bank, if such limitations are imposed by state law.
   b. Determine which guarantees are subject to individual loan limitations to any one customer by state law. Combine guarantees with any other extensions of credit to the account party by the issuing bank subject to loan limitations imposed by state law.
16. Perform appropriate procedural steps in the Concentration of Credits section, as applicable.
17. Discuss with appropriate officers and prepare summaries in appropriate report form of:
   a. Guarantees not supported by current and complete financial information.
   b. Guarantees on which collateral documentation is deficient.
   c. Concentrations of credit.
   d. Criticized guarantees.
   e. Inadequately collateraled guarantees, if applicable.
   f. Guarantees issued in favor of major shareholders, employees, officers, directors and related interests.
   g. Guarantees, which for any other reason, are questionable as to quality and ultimate collection.
   h. Violations of laws and regulations.
18. Evaluate the bank with respect to:
   a. The adequacy of written policies relating to guarantees issued.
   b. The manner in which bank officers are operating in conformance with established policy.
   c. Adverse trends within the guarantees issued department.
   d. The accuracy and completeness of the schedules obtained.
   e. Internal control deficiencies or exceptions.
   f. Recommended corrective action when policies, practices or procedures are deficient.
   g. The quality of departmental management.
   h. Other matters of significance.
19. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures for issuing and servicing guarantees. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written policies pertaining to guarantees issued that:
   a. Establish procedures for reviewing guarantee applications?
   b. Define qualified guarantee account parties?
   c. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
2. Are guarantees issued policies reviewed at least annually to determine if they are compatible with changing market conditions?

RECORDS

*3. Is the preparation and posting of subsidiary guarantee records performed or reviewed by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

*4. Are the subsidiary guarantees issued records balanced daily with the general ledger and are reconciling items adequately investigated by persons who do not normally handle guarantees?

*5. Are guarantee delinquencies prepared for and reviewed by management on a timely basis?

6. Are inquiries regarding guarantee balances received and investigated by persons who do not normally handle guarantees or post records?

*7. Are bookkeeping adjustments checked and approved by an appropriate officer?

*8. Is a daily record maintained summarizing guarantee transaction details, i.e., guarantees issued, guarantees cancelled or renewed, payment made under guarantees and fees collected, which support general ledger entries?

9. Are frequent guarantee instrument and liability ledger trial balances prepared and are they reconciled monthly with control accounts by persons who do not process or record guarantee transactions?

GUARANTEE FEES

*10. Is the preparation and posting of fees collected records performed or reviewed by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

11. Are independent fee computations made, compared or adequately tested to initial fee records by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

COLLATERAL

(See International—Loans and Current Account Advances section.)

OTHER

12. Are guarantees issued instruments safeguarded during banking hours and locked in the vault overnight?
13. Are all guarantees issued recorded as liabilities and assigned consecutive numbers?
14. Are all guarantees issued recorded on individual customer (account party) liability ledgers?

CONCLUSION

15. Is the foregoing information an adequate basis for evaluating internal control in that

there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

16. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

INTRODUCTION

This section is designed to provide examiners with the basic principles and risks associated with foreign exchange trading. By its very nature, foreign exchange trading involves risk. The examiner's primary function is to understand that risk and ensure that bank management, by means of policies, limits, and systems, is controlling that risk in a prudent manner. For the purpose of this section, foreign currency money market functions will be combined with foreign exchange activities since the principles and risks are virtually the same.

In order to evaluate a bank's foreign exchange and controls, the examiner needs a basic understanding of the foreign exchange market, the commercial bank's role in the market, trading fundamentals, and the principal risks involved in trading.

The foreign exchange market exists to service the foreign currency needs of importers, exporters, manufacturers, and retailers. Foreign exchange transactions arising from international trade and investment are frequently large and recurrent.

Large or small, all foreign exchange transactions represent the exchange of one country's money for another's. The exchange rate is simply the price of one currency in terms of another.

Until the late 1970s, foreign exchange rates in this country were normally expressed and quoted in dollars per unit of foreign currency, also known as ''U.S. Terms.'' Under this method, for example, the rate for French Francs would be expressed as Fl = U.S.$1.5500. However, because of vastly improved communications and a rapidly expanding market, it became necessary for traders worldwide to quote rates in a uniform manner. As a result, American foreign exchange traders began using foreign currency units per dollar or ''European Terms'' for most rates. Using European terms, the quote in this example would be U.S.$1 = F.64516. Thus, European terms represent the value of the U.S. dollar in units of the foreign currency. A quote in European terms is simply the reciprocal of a quote in U.S. terms. One major exception to this shift is the British pound sterling which, for historical purposes, is always quoted in U.S. terms such as 1£ = $1.7450.)

Any commercial bank which maintains due from bank balances, commonly known as ''nostro'' accounts, in foreign countries in the local currency has the capability of engaging in foreign exchange. The majority of U.S. banks restrict foreign exchange to the servicing of their customers' foreign currency needs. The banks will simply sell the currency at a rate slightly above the market and subsequently offset the amount and maturity of the transaction through a purchase from another correspondent bank at market rates. This level of activity involves virtually no exposure as currency positions are covered within minutes. A small profit is usually generated from the rate differential, but the activity is clearly designated as a service center.

Greater emphasis is placed on foreign exchange activity by regional banks. The servicing of the corporate customers' needs is also a priority, but most regional banks also participate in the interbank market. These banks look at the trading function as a profit center as well as a service. Such banks usually employ several experienced traders and, unlike the previous group, will take positions in given currencies based on anticipated rate movements.

Multinational banks assume, by far, the most significant role in the foreign exchange marketplace. While still servicing customer needs, these banks are heavily engaged in the interbank market and look to their foreign exchange trading operation for sizeable profits. Such banks trade foreign exchange on a global basis through international branch networks.

A major aspect of any foreign exchange review is the ability of the examiner to determine if the bank has the capability to adequately handle the level of its foreign exchange volume and the extent of the exposures taken. This judgment is, by necessity, subjective; however, it must take into consideration asset size, capital base, customer volume in foreign exchange, depth and experience of traders, and management understanding of and commitment to trading. The fundamental principles of foreign exchange trading outlined below are designed to assist the examiner in this analysis.

SPOT TRADING

Buying and selling foreign exchange at market rates for immediate delivery represents spot trading. In reality, spot trades have a ''value date'' (maturity or delivery date) of two to five business days (one for Canada and Mexico). Foreign exchange rates that represent the present market value for the currency are known as spot rates. The risk of spot trading results from rate movements occurring when the bank's position in foreign currency is not balanced with regard to exchange bought and sold. Such unbalanced positions are referred to as net open positions and are defined as follows:

Net Open Positions—A bank has a net position in a foreign currency when its assets, including spot and future contracts to purchase, and its liabilities, including spot and future contracts to sell, in that currency are not equal. An excess of assets over liabilities is called a net ''long'' position and liabilities in excess of assets a net ''short'' position. A ''long'' position in a foreign currency which is depreciating will result in an exchange loss relative to book value because, with each day, that position (asset) is convertible into fewer units of local currency. Similarly, a ''short'' position in a foreign currency which is appreciating represents an exchange loss relative to book value because, with each day, satisfaction of that position

CONSOLIDATED FOREIGN EXCHANGE POSITION, MAY 4, 19XX

Amounts in thousands

	Assets/Purchases		*Liabilities/Sales*	
Monetary Unit, Overnight Limit and Description	*Foreign Amount*	*U.S. $ Equivalent of Local Currency Book Value*	*Foreign Amount*	*U.S. $ Equivalent of Local Currency Book Value*
WEST GERMAN MARKS ($3,000M)				
Ledger Accounts	563,437	239,461	645,013	274,310
Spot Contracts	23,502	9,802	15,973	6,709
Forward Contracts	790,250	331,905	712,533	296,342
	1,377,189	581,168	1,373,519	577,361
Net Position (long)	3,670	3,807		
CANADIAN DOLLARS ($6,000M)				
Ledger Accounts	1,016,076	1,017,525	1,029,835	1,030,057
Spot Contracts	330,021	328,972	216,225	217,246
Forward Contracts	1,202,013	1,203,226	1,301,279	1,302,522
	2,548,110	2,549,723	2,547,339	2,549,825
Net Position (long)	771			102
SWISS FRANC ($250M)				
Ledger Accounts[1]	31,768	11,932	36,052	13,571
Spot Contracts	1,526	593	2,566	969
Forward Contracts	11,174	4,274	6,545	2,521
	44,468	16,799	45,163	17,061
Net Position (short)[2]			695	262

1. Does not include a Swiss Franc 1,000M (U.S. $386M) unhedged investment in a Swiss subsidiary and Swiss Franc 573M (U.S. $217M) unhedged investment in branch fixed assets. The unhedged term ''long'' position was approved by senior bank management.

2. Net overnight position in excess of established limit. Formally approved as a special situation by senior management prior to the transaction.

(liability) will cost more units of local currency. (Examples of net open position schedules appropriate for use in preparing the report of examination appear on the preceding page.)

It is important to remember that the net open position consists of both balance sheet accounts and contingent liabilities. For most banks, the nostro accounts represent the principal assets; however, foreign currency loans as well as any other assets or liability accounts denominated in foreign currency which are sizeable in certain banks, must be included. All future foreign exchange contracts outstanding are contingents. When a contract matures, the entries are posted to a nostro account in the appropriate currency.

Each time a bank enters into a spot foreign exchange contract, its net open position is changed. For example, assume that Bank A opens its business day with a balanced net open position in pound sterling (assets plus purchased contracts equal liabilities plus sold contracts). This is often referred to as a ‘‘flat’’ position. Bank A then receives a telephone call from Bank B requesting a ‘‘market’’ in sterling. Because it is a participant in the interbank foreign exchange trading market, Bank A is a ‘‘market maker.’’ This means it will provide Bank B with a two-sided quote consisting of its bid and offer for sterling. If a different currency was requested, European terms would be the opposite as the bid and offer would be for dollars instead of the foreign currency. In determining the market given, Bank A’s trader of sterling will determine where the market presently is (from brokers and/or other banks) and attempt to anticipate where it is headed and whether Bank B is planning to buy or sell sterling.

When Bank A gives its quote on sterling, $1.7115–25 for example, it is saying that it will buy sterling (its bid) at $1.7115 or sell sterling at $1.7125 (its offer). If Bank B’s interest is to buy sterling and the given quote is appealing, it will buy sterling from Bank A at $1.7125 (Bank A’s offer of sterling). Note, that while Bank B may choose to buy, sell or pass as it wishes, it must do business on the terms established by Bank A. These terms will be in Bank A’s favor. As soon as Bank B announces it will purchase sterling at $1.7125, Bank A acquires a net open position (short) in sterling. Bank A must then decide whether to hold its short position (in anticipation of a decline in sterling) or cover its position. Should it wish to cover, it may call another bank and purchase the amount it sold to Bank B. However, in this case, as the calling bank, Bank A would buy its sterling from the offered side of the quote it receives and must buy it at $1.7125 or less to avoid a loss.

Banks engaging in interbank spot trading will often be involved with sizeable net open positions, though many for just brief periods. No matter how skilled the trader, each will encounter at least occasional losses. Knowing when to close a position and take a small loss before it becomes large is a necessary trait for a competent trader. Many banks employ a ‘‘stop loss policy’’ whereby a net open position must be covered if losses from it reach a certain level. While a trader’s forecast may ultimately prove correct within a day or week, rapid rate movements often force a loss within an hour or even minutes. Also, access to up to the minute information is vital for involvement in spot trading. Banks who lack the vast informational resouces of the largest multinationals may be particularly vulnerable to sudden spot rate movements prompted by inside information or even rumors. As a result, examiners should closely review banks where foreign exchange activities consist primarily of interbank spot trading.

FORWARD TRADING

A forward transaction differs from a spot transaction in that the value date is more than two to five business days in the future. The maturity of a foreign forward exchange contract can be a few days, months, or even years in some instances. The exchange rate is fixed at the time the transaction is agreed. But nostro accounts are not debited or credited, i.e., no money actually changes hands, until the maturity date of the contract. There will be a specific exchange rate for each forward maturity, and each of those rates will generally differ from today’s spot exhange rate. If the forward exchange rate for a currency is higher than the current spot rate, dealers say the currency is trading at a ‘‘premium’’ for that forward maturity. If the forward rate is below the spot rate, then the currency is said to be trading at a ‘‘discount.’’ For instance, sterling for value in three months is at a discount if the spot rate is $1.75 and the three-month forward rate is $1.72.

Banks active in the foreign exchange market find that interbank currency trading for any specific value date in the future is inefficient and engage in it only infrequently. Instead, for future maturities, banks trade among themselves as well as with some corporate customers on the basis of a transaction known as a ‘‘swap.’’ A swap transaction is a simultaneous purchase and sale of a certain amount of foreign currency for two different value dates. The key aspect is that the bank arranges the swap as a single transaction with a single counterparty, either another bank or a nonbank customer. This means that, unlike outright spot or forward transactions, a trader does not incur a net open position since the bank contracts both to pay and to receive the same amount of currency at specified rates.

A swap allows each party to use a currency for a period in exchange for another currency that is not needed during that time. Thus, the swap offers a useful investment facility for temporary idle currency balances of a corporation or a financial institution. Swaps also provide a mechanism for a bank to accommodate the outright forward transactions executed with customers or to bridge gaps in the maturity structure of its outstanding spot and forward contracts.

The two value dates in a swap transaction can be any two dates. But, in practice, markets exist only for a limited number of standard maturities. One of these standard types is called a ‘‘spot against forward’’ swap. In a spot against forward swap transaction, a trader buys or sells a currency for the spot value date and simultaneously sells or buys it back for a value date a week, a month, or three months later.

Another type of transaction of particular interest to professional market-making banks is called a ‘‘tomorrow-next’’ swap or a ‘‘rollover.’’ These are transactions in which the dealer buys or sells a currency for value the next business day and simultaneously sells or buys it back for value the day after. A more sophisticated type of swap is called a ‘‘forward-forward’’ in which the dealer buys or sells currency for one future date and sells or buys it back for another future date. Primarily, multinational banks specialize in transactions of that type.

Any swap transaction can be thought of as if it were a simultaneous borrowing and lending operation. For example, on September 11, Bank A ‘‘swaps in’’ three-month sterling in a spot against a forward transaction with Bank B. On September 13, Bank A pays dollars to Bank B’s account at a New York bank and Bank A receives sterling for its account at a bank in London. On December 13, the swap is reversed. Bank A pays back the sterling to Bank B, while B pays back the dollars to A. In the meantime, Bank A has the use of the sterling, in effect ‘‘borrowing’’ sterling, while giving up use of the dollars, in effect ‘‘lending’’ the dollars. Banks recognize this close equivalence to actual short-term borrowing and lending. Many fold in swap transactions with other money market transactions in managing their global banking activities.

Forward exchange rates can be expressed in three ways. Like spot rates, outright forward prices are expressed in dollars and cents per currency unit or vice versa. Traders normally only quote forward prices to corporate customers or to small correspondent banks seeking to buy or sell a currency for a particular future date. For instance, a trader may quote an outright six-month rate to buy sterling of $1.8450, while, by comparison, a quotation to buy spot sterling might be less ($1.8200) or more ($1.8625).

In swap transactions, the trader is only interested in the difference between spot and forward rates, the premium or discount, rather than the outright spot and forward rates themselves. Premiums and discounts expressed in points ($0.0001 per pound sterling or DM 0.0001 per dollar) are called swap rates. For the first spot rate above, the premium is 250 points ($0.0250). For the second, the discount is 175 points ($0.0175).

Since, in a swap, a trader is effectively borrowing one currency and lending the other for the period between the two value dates, the premium or discount is often evaluated in terms of percent per annum. For the examples above, the premium of 250 points is equivalent to 2.75 percent per annum, while the discount of 175 points is equivalent to 1.88 percent per annum. To calculate the percentage premium for the first case:

- Take the swap rate ($0.0250)
- Multiply by 12 months and divide by 6 months (a per annum basis)
- Divide by the spot rate ($1.8200), and
- Multiply by 100 (to get a percent basis).

On a formula basis, this can be expressed as:

$$\text{\% per annum} = \frac{\text{Premium or Discount} \times 12 \times 100}{\text{Spot rate} \times \text{number of months of forward contract}}$$

As can be seen from the above, forward rates (premiums or discounts) are solely influenced by the interest rate differentials between the two countries involved. As a result, when the differential changes, forward contracts previously booked could now be covered at either a profit or loss. For example, assume an interest rate differential between sterling and dollars of 3 percent (with the sterling rate lower). Using this formula, with a spot rate of $1.80, the swap rate on a three month contract would be a premium of 135 points. Should that interest rate differential increase to 4 percent (by a drop in the sterling rate or an increase in the dollar rate), the premium would increase to 180 points. Therefore, a trader who bought sterling three months forward sterling at 135 points premium could now sell it at 180 points premium, or at a profit of 45 points (expressed as .0045).

Thus, the dealer responsible for forward trading must be able to analyze and project dollar interest rates as well as interest rates for the currency traded. Additionally, because forward premiums or discounts are based on interest rates differentials, they do not reflect anticipated movements in spot rates.

Active trading banks will, of course, have a large number of forward contracts outstanding. The portfolio of forward contracts is often called a ‘‘forward book.’’ As a result, these forward positions must be managed on a gap basis. Normally, banks will segment their forward books into 15-day periods and show the net (purchased forward contracts less sold ones) balance for each period. A typical forward book would look as follows:

Foreign Currency	*Maturity Date*	*Purchases*	*Sales*	*Net Position for Period*
England	Dec. 1–15	1 000 000	800 000	200 000
(amounts in)	16–31	700 000	900 000	(200 000)
pound sterling)	Jan. 1–15	1 500 000	500 000	1 000 000
	16–31	1 400 000	600 000	800 000
	Feb. 1–15	1 100 000	700 000	400 000
	16–28	1 400 000	400 000	1 000 000
	Mar. 1–31	200 000	1 300 000	(1 100 000)
	Apr. 1–30	400 000	1 600 000	(1 200 000)
	May 1–31	300 000	900 000	(600 000)
	June 1–30	350 000	450 000	(100 000)
	July 1–31	550 000	450 000	100 000
	Aug. 1–31	1 000 000	1 000 000	—
	Sept. 1–30	500 000	600 000	(100 000)
	Oct. 1–31	600 000	500 000	100 000
	Nov. 1–30	100 000	100 000	—
	Dec. 1–31	100 000	200 000	(100 000)
	Totals	11 200 000	11 000 000	200 000

In this forward book, volumes and net positions are limited with only the first three months segregated into 15-day periods with the remainder grouped monthly. The trader will use the forward book to manage his overall forward positions.

A forward book in an active currency may consist of numerous large contracts but, because of the risks in a net open position, total forward purchases will approximately equal total forward sales. (Note: In the above forward book, the net position is only £200,000.) What matters in reviewing a forward book is the distribution of the positions by period. In the above example, the forward sterling is long a net 3,200,000 for the first three months (December through February) and short a net 3,000,000 for the next four months (March through June). In this instance, the forward book is structured for an anticipated decline in dollar interest rates as compared with sterling interest rates since these sold positions could be offset (purchase of a forward contract to negate the sold forward position) at a lower price—either reduced premium or increased discount.

Trading forward foreign exchange thus involves projecting interest rate differentials and managing a forward book to be compatible with these projections. An understanding of these concepts is essential when looking at forward trading from risk and profitability aspects.

COMPUTING FOREIGN EXCHANGE PROFITS AND LOSSES

If traders did nothing but spot transactions and never took open positions from day to day, calculating profit or loss would be straightforward. For example: on January 21, the traders buy £1,000,000 spot at $1.75 and £3,000,000 at $1.74 and sell £2,000,000 at $1.7450 and £2,000,000 at $1.7380. On the spot value dates, two business days later, the bank's nostro or clearing account in London is credited and debited by £4,000,000 from the maturing transactions.

The sterling position is square, since debits and credits are equal. In New York, the bank pays $6,970,000 but receives only $6,966,000. There is a net loss of $4,000 on the four transactions. This is so because the bank's accountant would calculate that the traders acquired sterling at an average rate of $1.7425 =

$$\frac{£1{,}000{,}000 \times \$1.75 + £3{,}000{,}000 \times \$1.74}{£4{,}000{,}000}$$

Against that, the traders sold sterling at $1.7450, for a profit of $5,000 (i.e., $1.7450 – $1.7425 = $0.0025 × 2,000,000 = $5,000). Traders also sold another £2,000,000 at $1.7380 for a loss of $9,000 ($1.7380 – $1.7425 = –$0.0045 × £2,000,000 = –$9.000). In this instance, the computed net loss of $4,000 is precisely the same as the excess of dollar payments over dollar receipts.

In practice, computing profits and losses is far more complex for two basic reasons. Banks do not trade only for spot value—they also do forward contracts. Moreover, most major banks do not operate from day to day with completely square positions in each currency. Because of the way different forward contracts mature each day, it is unusual for payments and receipts to balance perfectly until the traders arrange swaps to achieve that result. Because some traders take a view about the future movements of a currency, short or long positions are built up; and, because of the changing influences on market developments and traders' decisions, long or short positions can be altered any number of times each and every day.

In this kind of fluid trading environment, a bank needs to establish accounting procedures for calculating profits and losses which can handle the problem of maturity mismatches and open foreign currency positions. The principles underlying the accounting procedures are much the same from bank to bank, although specific practices vary. The first principle is that banks do not formally calculate profits or losses daily; most compute profits and losses monthly. Some banks do make these calculations more frequently for management information purposes.

The next principle is that banks calculate profits or losses on the entire foreign exchange book as of the calculation date. On any day, the book includes all spot and forward contracts which have not yet matured, along with nostro balances in each currency. Each contract represents a purchase or sale of a foreign currency at a specified exchange rate.

On the profit calculation date, the bank's accountants revalue the foreign exchange book. They use the latest market exchange rates, spot and forward, for each value date on which contracts are outstanding. For each contract, the difference between the current market rate for the value date of the contract and the rate specified in the contract is calculated. For example, if the bank previously bought a currency, e.g., sterling at $1.75, and the current market rate for the relevant maturity is higher, e.g., sterling at $1.80, there is an unrealized profit.

These calculated unrealized profits and losses are amalgamated with the realized profits or rlosses that accrue every day as foreign exchange contracts mature. The net profit or loss, realized plus unrealized, is then incorporated in bank operating income, reflecting the net contribution of foreign exchange trading before expenses.

To recapitulate, a bank with a large number of spot and forward contracts and possibly with open positions in one or more currencies needs a formal method of computing unrealized profits and losses at regular intervals. It uses a revaluation procedure that, in effect, measures what the profits and losses would be if the bank covered in the market all outstanding positions that were not already covered. The revaluation procedure ensures that the bank's open positions show changes in exchange rates as they occur, rather than when open positions are eventually covered or when individual contracts mature. Periodic profit and loss calculations therefore provide bank management with ongoing insights into the performance of the trading function.

Following is an illustration of the revaluation procedure. Assume that on the revaluation date, January 15, Bank A had three outstanding contracts in its sterling book:

- A sale of £1,000,000 at $1.75 for value March 15.
- A purchase of £3,000,000 at $1.70 for value May 15.
- A sale of £1,000,000 at $1.65 for value August 15.

The book is ''long'' £1,000,000 since purchases of sterling are greater than sales. For now, the nostro account and the calculations of realized profits and losses are left aside.

To revalue the book, the accountants find on January 15 that two-month, four-month, and seven-month forward rates in the market are $1.80, $1.75, and $1.70, respectively. They proceed conceptually as if the traders were to cover the contracts at the going market rates, buying sterling to offset sales and selling sterling to offset purchases. On this basis, for the first contract, they compute an urealized loss of $50,000 ($1.75 – $1.80 = –$0.05 × £1,000,000). For the second contract, they compute an unrealized profit of $150,000 ($1.75 – $1.70 = $0.05 × £3,000,000). For the third contract, they compute an unrealized loss of $50,000 ($1.65 – $1.70 = $0.05 × £1,000,000). The net is an unrealized profit of $50,000 which is entered on the income statement as the trading profit.

The accountant's task actually is far more complicated. A foreign exchange book of a major bank may include hundreds of outstanding contracts in a dozen or more currencies. Value dates range from the next day to a year or more in the future. Market exchange rates are readily available for the ''even'' dates—one, two, three, six, twelve, and twenty-four months into the future. The Federal Reserve Bank of New York publishes such a daily series which can be used by bank accountants and examiners. But for ''odd'' dates, the accountant must approximate rates, possibly through a computer program that interpolates between even date quotations.

As contracts in the foreign exchange book mature, they affect the cash flow of the bank. Maturing purchase and sale contracts are treated asymmetrically. In a U.S. bank, which posts its profits and losses in dollars, maturing purchase contracts result in credits to its nostro account in that currency. Each day, the bank's accountants compute a new average acquisition rate for the nostro account based on existing holdings and all flows into the account that day. Maturing sale contracts result in debits to the nostro account. They yield a gain or loss measured against the average acquisition rate for funds available in the nostro account. The net realized profit or loss is placed in a suspense account which, at regular intervals, is incorporated into the bank's income statement along with the unrealized profits or losses resulting from the periodic revaluation of the foreign exchange book. In practice, the revaluation can be done on a worksheet as long as net positions for time periods and present market rates are known. While banks will revalue monthly and make the appropriate entries to income accounts, traders will spot-check their profitability more frequently. Examiners should understand the revaluation procedure for the necessary test checking of reported profits, as time restrictions do not normally allow for the proving of all of the bank's open positions.

To revalue the nostro accounts, which represent realized profit or loss, the net foreign currency balance is multiplied by the current spot rate and the result, or market value, is compared to the U.S. $ equivalent on the books to determine profit or loss as shown below:

Foreign Amount	*Spot Rate*	*Market Value*	*U.S. $ Equivalent Book Value of Ledger Accounts*	*Profit or Loss*
15,172	$1.7155	26,028	21,229	+4,799

The same principle holds true when comparing market value to book, even if credit balances exist. (A market value of −19.055 and a book value of −20,155 would result in a profit of 1,100.)

A worksheet revaluation of forward contracts, for unrealized profits, is an expansion of the forward book previously shown. All rates must be expressed in "U.S. terms."

FORWARD BOOK

Foreign Currency	*Maturity Date*	*Purchases*	*Sales*	*Net Position for Period*	*D-Discount P-Premium Rate*	*Profit*	*Loss*
England	Dec. 1–15	1 000 000	800 000	200 000	.0025 P	500	
	16–31	700 000	900 000	(200 000)	25 P		500
	Jan. 1–15	1 500 000	500 000	1 000 000	15 P	1,500	
	16–31	1 400 000	600 000	800 000	15 P	1,200	
	Feb. 1–15	1 100 000	700 000	400 000	5 P	200	
	16–28	1 400 000	400 000	1 000 000	5 P	500	
	Mar. 1–31	200 000	1 300 000	(1 100 000)	5 D	550	
	Apr. 1–30	400 000	1 600 000	(1 200 000)	15 D	1,800	
	May 1–31	300 000	900 000	(600 000)	30 D	1,800	
	June 1–30	350 000	450 000	(100 000)	45 D	450	
	July 1–31	550 000	450 000	100 000	5 P	50	
	Aug. 1–31	1 000 000	1 000 000	—	25 D	—	
	Sept. 1–30	500 000	600 000	(100 000)	0	—	
	Oct. 1–31	600 000	500 000	100 000	45 D		450
	Nov. 1–30	100 000	100 000	—	25 D	—	
	Dec. 1–31	100 000	200 000	(100 000)	5 P		50
	Totals	11 200 000	11 000 000	200 000		+7550	

In completing a worksheet in the above format, the following must be kept in mind:

- A long position at a premium = profit
- A short position at a premium = loss
- A long position at a discount = loss
- A short position at a discount = profit

The $7,550 is simply the profit that would be obtained if the forward book positions were fully liquidated at this time, i.e., purchases offset by sales. To calculate the profit, the unrealized profit from the previous month ($6,400 in this example) must be reversed. Thus, the sterling profit for this month would be:

$4,799	Nostro balance profit
7,550	Forward book profit (unrealized)
−6,400	Reversal of last month's forward book
$5,949	Sterling profit for the month

Most automated systems will eliminate the need for manual calculations. However, the resulting figure is only as accurate as the rates applied. As a result, examiners should test-check at least one major currency using independent rates (supplied by the Federal Reserve Bank of New York or another independent source). This should be done concurrently with the bank's own monthly revaluation. If a sizeable discrepancy results, rates and revaluation methods used by the bank should be reviewed with both management and the traders.

DEFINING AND CONTROLLING FOREIGN EXCHANGE RISKS

Foreign exchange trading encompasses a variety of risks. Exchange rate risk, maturity gaps and interest rate risk relate to spot and forward trading. The latter two risks relate to exposures inherent in all phases of international banking.

Exchange Rate Risk

Exchange rate risk is an inevitable consequence of trading in a world in which foreign currency values move up and down in response to shifting market supply and demand. When a bank's dealer buys or sells a foreign currency from another bank or nonbank customer, exposure from a net open position is created. Until the time that the position can be covered by selling or buying an equivalent amount of the same currency, the bank is exposed to the risk that the exchange rate might move against it. That risk exists even if the dealer immediately seeks to cover the position because, in a market in which exchange rates are constantly changing, a gap of just a few moments can be long enough to transform a potentially profitable transaction into a loss. Since exchange rate movements can readily accumulate in one direction, a position carried overnight or over a number of days entails greater risk than one carried a few minutes or hours. Again, the acid test of a good trader is to know when to take a small loss before it becomes larger.

At any time, the trading function of a bank may have long positions in some currencies and short positions in others. These positions do not offset each other, even though, in practice, some currencies do tend to move more or less together. The bank's traders recognize the possibility that the currencies in which they have long positions may fall in value and currencies in which they have short positions may rise. Consequently, gross trading exposure is measured by adding the absolute value of each currency position expressed in dollars. The individual currency positions and the gross dealing exposure must be controlled to avoid unacceptable risks.

To accomplish this, management limits the open positions dealers may take in each currency. Practices vary among banks, but, at a minimum, limits are established on the magnitude of open positions which can be carried from one day to the next (overnight limits). Several banks set separate limits on open positions dealers may take during the day. These are called "daylight" limits. Formal limits on gross dealing exposure also are established by some banks, while others review gross exposure more informally. The various limits may be administered flexibly, but the authority to approve a temporary departure from the norm is typically reserved for a senior officer.

For management and control purposes, most banks distinguish between positions arising from actual foreign exchange transactions (trading exposure) and the overall foreign currency exposure of the bank. The former includes the positions recorded by the bank's trading operations at the head office and at branches abroad. In addition to trading exposure, overall exposure incorporates all bank assets and liabilities denominated in foreign currencies including loans, investments, deposits, and the capital of foreign branches. Control of overall foreign currency exposure usually is the responsibility of a senior officer accountable to the bank's senior management.

Maturity Gaps and Interest Rate Risk

Interest rate risk arises whenever there are mismatches or gaps in the maturity structure of a bank's foreign exchange forward book. Managing maturity mismatches is an exacting task for a foreign exchange trader.

In practice, the problem of handling mismatches is involved. Eliminating maturity gaps on a contract-by-contract basis is impossible for an active trading bank. Its foreign exchange book may include hundreds of outstanding contracts. Some will mature each business day. Since the book is changing continually as new transactions are made, the maturity gap structure also changes constantly.

While remaining alert to unusually large mismatches in maturities that call for special action, traders generally balance the net daily payments and receipts for each currency through the use of rollovers. Rollovers simplify the handling of the flow of maturing contracts and reduce the number of transactions needed to balance the book. Reliance on day-to-day swaps is a relatively sound procedure as long as interest rate changes are gradual and the size and length of maturity gaps are controlled. However, it does leave the bank exposed to sudden changes in relative interest rates between the United States and other countries, which influence market quotations for swap transactions and, consequently, the cost of bridging the maturity gaps in the foreign exchange book.

The problem of containing interest rate risk is familiar to major money market banks. Their business often involves borrowing short-term and lending longer-term to benefit from the normal tendency of interest rates to be higher for longer maturities. But in foreign exchange trading, it is not just the maturity pattern of interest rates for one currency that counts. Rather, in handling maturity gaps, the differential between interest rates for two currencies is decisive. So the problem is more complex.

To control interest rate risk, senior management generally imposes limits on the magnitude of mismatches in the foreign exchange book. Procedures vary, but separate limits are often set on a day-to-day basis for contracts maturing during the following week or two and for each consecutive half-monthly period for contracts maturing later. At the same time, management relies on branch officers abroad, domestic money market experts, and its Economic Research Department to provide an ongoing analysis of interest rate trends.

Credit Risk

When a bank books a foreign exchange contract, it faces a risk, however small, that the counterparty will not perform according to the terms of the contract. In both instances, there is a credit risk, although, in the foreign exchange case no extension of credit is intended. To limit credit risk, a careful evaluation of the creditworthiness of the customer is essential. Just as no bank can lend unlimited amounts to a single customer, no bank would want to trade unlimited amounts of foreign exchange with one counterparty.

Credit risk arises whenever a bank's counterparty is unable or unwilling to fulfill its contractual obligations. That happens most blatantly when a corporate customer enters bankruptcy or a bank counterparty is declared insolvent. In any foreign exchange transaction, each counterparty agrees to deliver a certain amount of currency to the other on a particular date. Every contract is immediately entered into the bank's foreign exchange book. In balancing its trading position, a bank counts on that contract being carried out in accordance with the agreed upon terms. If the contract is not liquidated, then the bank's position is unbalanced and the bank is exposed to the risk of changes in the exchange rates. To put itself in the same position it would have been in if the contract had been performed, a bank must arrange for a new transaction. The new transaction may have to be arranged at an adverse exchange rate. The trustee for a bankrupt company may perform only contracts which are advantageous to the company and disclaim those contracts which are disadvantageous.

Another and potentially more pernicious form of credit risk stems from the time zone differences between the United States and foreign nations. Inevitably, a bank selling sterling, for instance, must pay pounds to a counterparty earlier in the day than it will be credited with dollars in New York. In the intervening hours, a company can go into bankruptcy or a bank can be declared insolvent. Thus, the dollars may never be credited.

Managing credit risk is the joint responsibility of the bank's trading department and its credit officers. A bank normally deals with corporations and banks with which it has an established relationship. Dealing limits are set for each counterparty and are adjusted in response to changes in its financial condition. In addition, some banks set separate limits on the value of contracts that may mature on a single day with a particular customer. Some banks, recognizing credit risk increases as maturities lengthen, restrict dealings with certain customers to spot transactions or require compensating balances on forward transactions. A bank's procedures for evaluating credit risk and minimizing exposure are reviewed by supervisory authorities as part of the regular examination process.

Transfer Risk

At one time or another, virtually every country has interfered with international transactions in its currency. Interference might take the form of regulation of the local exchange market, restrictions on foreign investment by residents, or limits on inflows of investment funds from abroad. Governments take such measures for a variety of reasons: to improve control over the domestic banking system, or to influence the pattern of receipts and payments between residents and foreigners. Restrictions on the exchange market or on international transactions generally are intended to affect the level or movement of the exchange rate.

Changes in regulations or restrictions usually do have an important exchange market impact. From the viewpoint of a commercial bank's foreign currency traders, most disruptive are changes in rules which interfere with the normal payments mechanism. Traders make foreign exchange contracts on the expectation that both parties will perform according to the terms of the contract. But if government regulations change and a counterparty is either forbidden to perform as expected or is required to do something extra, then a trader might be left with an unintended open position or an unintended maturity mismatch. As described in the previous section, dealing with unintended long or short positions can be costly.

Other changes in official regulations do not in the first instance, affect the payments mechanism, but they do influence international investment transactions. Consequently, when one of the factors affecting the buying or selling of a currency changes, the exchange rate is likely to respond. Currency traders usually try to limit open positions and maturity gap mismatches, whenever modifications in official regulations appear likely. Nevertheless, changes in controls often are unpredictable; and unanticipated changes in regulations can spark significant exchange rate response.

Monitoring and responding to changing official exchange controls abroad has to be done by a well-run foreign exchange trading function. Most U.S. banks have judged that the simplest approach is to avoid trading in those currencies for which the market is heavily regulated. This decision is reflected in turnover statistics which show that trading is concentrated in the major currencies subject to the fewest controls; generally the West German deutsche mark, Canadian dollar, British pound sterling, Swiss franc, French franc, Italian lira, Japanese yen, Dutch guilder, and Danish kroner.

POLICY

The relative importance of each of those risk determinants varies with each currency traded and with the country of each counterparty. Senior bank management must fully understand the risks involved in foreign exchange and money market operations and must establish, in writing, its goals and policies regarding those risks. Management must be able to defend logically the basis upon which such policies are formed. It is imperative that responsible officers, traders, clerks and auditors fully understand the intent as well as the detail set forth in those directives.

At a minimum, policies should define dealing limits and reporting requirements as well as accounting and audit and control systems to provide for proper surveillance over those limits and exceptions thereto.

Limits must be established for overnight net positions in each currency. Depending on the size of the limits and the manner in which they are calculated, a smaller aggregate position limit for all currencies may be desirable. An aggregate limit should not permit the netting of short against long positions, but should require that they be added to determine conformance to that limit. Many U.S. banks consider whether to establish daylight (intraday) position limits only if efficient computerization and input systems are in effect to incorporate each trade into the appropriate currency position at nearly the precise moment it is transacted.

Gap (net inflow and outflow) limits must be instituted to control the risk of adverse rate movement and liquidity pressures for each currency for each daily, weekly, and biweekly future time frame designated in the bank's maturity reports. Such limits might range from stated absolute amounts for each time frame to weighted limits which emphasize increasing rate movement exposure applicable to the relative distance into the future in which the gap appears.

Aggregate trading and placement limits must be established for each customer, based primarily on the amount of business considered to be appropriate to its creditworthiness and, secondly, on the volume of its foreign currency needs. In addition, absolute sub-limits should be placed upon the amount of that customer's business which may be settled on one day. Should the customer be unable to meet obligations on one day, the trader will:

- Be forewarned against delivery prior to receipt of customer funds on the remaining contracts outstanding, and
- Have an opportunity to determine whether alternate cover must be obtained to meet third-party transactions which may initially have provided cover for the remaining transactions with that customer.

It is difficult to monitor aggregate volume limits effectively and ensure compliance with settlement limits for a large number of customers. An effective settlement limit program for at least those relationships which possess a greater potential for late delivery or default should be enacted by senior management.

REPORTS

Properly designed reports are the most important supervisory tool available to management. They must be prepared in a concise, uniform and accurate manner and submitted punctually. Management should receive daily net position reports for each currency traded. Normally, position reports should include all foreign currency balance sheet items and future contracts as well as afterhour and holdover transactions, excepting fixed assets and equity investments. The hedging of those investments is usually a management decision outside the normal responsibility of the traders. The reports should be prepared by the foreign exchange and money market bookkeeping section and reconciled daily to the trader's blotter. In the event that formal position reports cannot be submitted at the end of a business day, management should be apprised of the traders estimated position at the end of each day and especially before weekends and holidays.

Gap or maturity reports are essential to the proper management of a bank's liquidity in each foreign currency and significant maturity gaps may affect overall liquidity. Those reports should show daily gaps for at least the first two weeks to one month. Beyond that time, gap periods of a maximum of two weeks each are preferred. Gap reports are generally accurate only for the day on which they are prepared. Therefore, it is essential that banks have the capability to produce detailed management reports daily. Loans, deposits and future contracts as well as commitments to take or place deposits should be reflected in the periods in which they are scheduled for rollover or interest adjustment. In most instances, an additional report showing those items at final maturity is desirable in analyzing the bank's medium- and longer-term dependence on money market funding sources.

Exception reports must be promptly generated upon the creation of excesses to position limits, gap limits and customer trading and settlement limits. Excesses over any established limits should conform to overall policy guidelines and should receive prior approval by the responsible supervisory officers. If prior approval is not possible, evidence of subsequent officer concurrence or disagreement as well as any corrective action should be available for audit review and management records.

REVALUATION AND ACCOUNTING SYSTEMS

Revaluation and accounting systems should be in place to accurately determine actual as well as estimated future profits and losses and to present them in such a manner as to facilitate proper income analysis by management, bank supervisory personnel and the public. As previously described, a bank's revaluation procedure should be test-checked at the time of monthly revaluation using independently obtained rates. While methods and systems may vary to some degree within banks, all revaluation systems should incorporate the following two aspects:

- Actual realized profit or loss as determined by applying current spot rates to balance sheet accounts as well as contracts of near maturities. Adjustments to the local currency book values would either be allocated and posted to each of the applicable local currency ledger accounts or, for short interim periods, be charged to a separate foreign exchange adjustment account with an offset to the profit and loss account.
- Unrealized (estimated future) profit or loss on future transactions as determined by applying the appropriate forward rates to the net positions shown for each future period appearing in the bank's gap or maturity reports. The account ‘‘estimated profit (loss) on foreign exchange—futures’’ is to be charged for the amount of the adjustment with an offset to the profit and loss account. Provided that the amount of that adjustment is the difference between the existing forward rates and the actual contract rates, each month's entries merely involve reversing the adjustment from the prior revaluation and entering the new figures.

SPECIALIZED TRANSACTIONS

Financial Swaps

A financial swap is the combination of a spot purchase or sale against a forward sale or purchase of one currency in exchange for another. It is merely trading one currency (lending) for another currency (borrowing) for that period of time between which the spot exchange is made and the forward contract matures. The swap is the simple identification of one transaction contracted at the spot rate with another transaction contracted at the forward rate to establish the exchange cost or profit related to the temporary movement of funds into another currency and back again. That exchange (swap) profit or cost must then be applied to the rate of interest earned on the loan or investment for which the exchange was used. For example, the true yield of an investment for 90 days in United Kingdom Treasury bills cannot be determined without having considered the cost or profit resulting from the swap needed to make pounds sterling available for that investment. Likewise, the trading profits or losses generated by the trader cannot be determined if financial swap profits and expenses are charged to the exchange function rather than being allocated to the department whose loans or investments the swap actually funded.

Arbitrage

As it pertains to money markets and foreign exchange, arbitrage may take several forms. The creation of an open position in a currency in anticipation of a favorable future movement in the exchange rate, in addition to being speculative, is sometimes referred to as "arbitrage in time." Buying a currency in one market and simultaneously selling it for a profit in another market is called "arbitrage in space." Slightly more involved is the practice of interest arbitrage which involves the movement of funds from one currency to another so they may be invested at a higher yield. The real yield advantage in such a situation is not determined merely by the difference in interest rates between the two investment choices, but rather, by subtracting the cost of transferring funds into the desired currency and back again (the swap cost) from the interest differential. For example, there is no arbitrage incentive involved in swapping from dollars into the other currency at a 60 point per month discount (swap cost) which exactly offsets the 3 percent gain in interest. However, should the swap rate move to 40 points per month (or 480 points per year), the investment might become attractive. This can be tested by converting the swap rate to an annual percentage rate:

$$\frac{\text{Discount or Premium} \times 360 \times 100}{\text{Spot rate} \times \text{No. of days of future contract}} = \%\ \text{P.A.}$$

$$\frac{.0040 \times 360 \times 100}{2.4000 \times 30} = 2\%\ \text{P.A.}$$

This results in a true yield incentive of 1 percent, 3 percent less the swap cost of 2 percent.

Unless the bank's accounting system can identify swap costs or profits and allocate them to the investments for which they were entered, both the earnings on those investments and the earnings upon which the trader's performance are measured will be misstated.

Options

Option contracts permit a bank to contract to buy from or sell to a customer when that customer can only generally predict the dates when the currency will be required. The option contract specifies the dates, and the rate cited is that which, in the judgment of the trader at the time of making the contract, contains the least exposure for the bank. This type of contract is commonly requested by commercial customers who wish to cover drafts drawn under letters of credit denominated in a foreign currency. Such contracts involve more risk as there is no way for the bank to acquire a precisely matching cover.

Compensated Contracts

There are occasions when both parties are agreeable to altering the terms of an existing contract. Such alterations should be approved by a bank officer without responsibilities in the trading room and the operations personnel must be advised of each compromise to avoid settlement in accordance with the original instructions and terms.

OTHER RELATED MATTERS

Departmental Organization and Control

It is imperative that there be a distinct separation of duties and responsibilities between the trading and the accounting and confirmation functions within the department. Many opportunities exist to avoid established limits and policies or for personal financial gain, whether by speculating beyond loosely controlled limits, concealing contracts because of poor confirmation procedures or by simple fraud. Periodic audits and examinations are no substitute for the existence of sound safeguards.

Supervision of Branches and Subsidiaries

Whether a bank maintains central control over all foreign exchange and money market activities at the head office or elects to decentralize that control, the policies, systems, internal controls and reporting procedures should not differ among separate offices within the bank.

The bank should be apprised of its worldwide positions by daily summary reports. Detailed net position and maturity gap reports should be received periodically in order to prepare consolidated positions, as required, and to monitor individual unit trading volume and funding methods. Information provided in the Treasury Department monthly foreign currency reports is adequate for the preparation of reports of examination and can be adapted easily to reporting for currencies other than those specified in the reporting instructions.

FEDERAL FINANCIAL INSTITUTIONS EXAMINATIONS COUNCIL UNIFORM GUIDELINES

The ‘‘Uniform Guideline on Internal Control for Foreign Exchange in Commercial Banks,’’ as adopted by the three federal bank regulatory agencies, established minimum standards for documentation, accounting and auditing for foreign exchange. Most of these standards have already been incorporated into the Foreign Exchange Internal Control Questionnaire in this section. See the appendix for the text of these guidelines.

(Source: Excerpts from ‘‘Foreign Exchange Markets in the United States’’ by Roger M. Kubarych of the Federal Reserve Bank of New York have been incorporated into this section.)

1. To determine if the policies, practices, procedures and internal controls regarding foreign exchange activities are adequate.
2. To determine if bank officers, traders and clerks are operating within the established guidelines.
3. To determine the extent of risk attributable to net open positions, maturity gaps and counterparty credit weakness.
4. To determine the scope and adequacy of the audit function.
5. To determine if the revaluation and accounting systems are adequate and accurately reflect the results of the trading operation.
6. To determine compliance with laws and regulations.
7. To initiate corrective action when policies, practices, procedures or internal controls are deficient, or when violations of laws or regulations have been noted.

1. If selected for implementation, complete or update the foreign exchange section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal and external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal/external auditors, and determine if appropriate corrections have been made.
4. Obtain a trial balance, including local currency book values, of customer spot and future contract liabilities by customer and by maturities and:
   a. Agree or reconcile balances to appropriate subsidiary controls and to the general ledger.
   b. Review reconciling items for reasonableness.
5. Review foreign currency and appropriate local currency subsidiary control ledgers to determine that for each local currency entry there is an accompanying foreign currency entry unless they represent:
   a. Brokerage charges to the local currency ledger.
   b. Profit and loss adjustments to the local currency ledger.
   c. Correction of errors in either ledger.
6. Provide liability and other information on common borrowers to the examiner assigned to "International—Loans and Current Account Advances."
7. Identify those contracts with counterparties who are affiliates of or otherwise relatead to the bank, its directors, officers, employees, or major shareholders, and
   a. Compare the contracted rates with available rates for the same transaction date or with other similar contracts entered as of the same transaction date.
   b. Investigate any instances involving off-market rates.
8. Perform an independent revaluation of at least one major currency using rates obtained from independent sources, and compare results to the accounting department's monthly foreign exchange profit and loss entries.
9. Check the most recent revaluation workpapers and resultant accounting entries to determine that:
   a. Foreign currency amounts and book values were properly reconciled to subsidiary ledger controls.
   b. Rates used are representative of market rates as of revaluation date.
   c. Arithmetic is correct.
   d. Profit and loss results are separately recorded and reported to management for:
      - Realized profit or loss, i.e., that which is determined through the application of spot rates.
      - Unrealized (estimated future) profit and loss, i.e., that which is determined through the application of forward rates.
   e. Financial swap related assets, liabilities and future contracts are excluded from the normal revaluation process so that the results identified in step 9d reflect more accurately the trader's outright dealing performance.
   f. Financial swap related costs and profits are:
      - Amortized over the life of the applicable swap.
      - Appropriately accounted for as interest income and expense on loans, securities, etc. Test financial swap income and expense calculations and verify the accounting entries.
10. Review workpapers for selected revaluations performed since last examination. Test-check and, if satisfied that they are accurate,
    a. Analyze combined realized earnings to determine that profits are commensurate with risks taken.
    b. Analyze monthly unrealized revaluation results (forecasts) to determine that:
       - The resulting amount for the last revaluation, if loss, is not large.
       - An increasing loss trend over previous revaluations does not exist. (Although month-to-month variations are not uncommon, an increasing unrealized loss trend could indicate that a trader is

caught in a loss position and is pursuing a notion that a negative trend in the exchange rate for that currency will reverse and, if combined with an ever multiplying increase in volume, might eventually be able to repay accumulated losses.)

11. Obtain the percentage of total contracts outstanding (dollar value of purchases plus sales that are with corporate customers). Analyze this percentage in regard to trend and comparison, if possible, to banks with similar trading volume. Ascertain if corporate volume is commensurate with written policy in regards to purpose and scope of the foreign exchange trading function.
12. Determine compliance with laws and regulations pertaining to foreign exchange activities by performing the following for Foreign Currency Forms FC–1, FC–1a, FC–2, and FC–2a:
    a. Obtain the most recently prepared monthly and weekly reports and review for accuracy.
    b. Select random bank-prepared daily net position reports for Wednesdays and month-end business days and test to see that:
        - Reports are being filed as required.
        - Reports are accurate.

        Be aware of instances in which net positions are generally large but reduced as of Wednesday and month-end reporting dates.
13. Discuss with appropriate officers and prepare in appropriate report format:
    a. Net position schedules.
    b. Maturity gap schedules.
    c. Frequent or sizeable excesses over any established limits.
    d. Any limits deemed excessive relative to:
        - Management's policy goals regarding the nature and volume of business intended.
        - The bank's capital structure.
        - The creditworthiness of trading counterparties.
        - Individual currencies which are subject to or are experiencing relatively sporadic rate changes.
        - Individual currencies for which limited spot and future markets exist.
        - Experience of traders.
        - The bank's foreign exchange earnings record.
    e. The absence of any limits deemed appropriate in present and foreseeable circumstances.
    f. Customers whose obligations are otherwise previously classified or intended to be criticized.
    g. Foreign exchange contracts which, for any other reason, are questionable in quality or ultimate settlement.
    h. Violations of laws and regulations.
    i. Deficiencies in internal controls.
    j. Other matters regarding the efficiency and general condition of the foreign exchange eepartment.
14. Update the workpapers with any information that will facilitate future examinations.

A review of the bank's internal controls, policies, practices and procedures regarding foreign exchange trading is essential to ensure no excessive risk or exposures exist. The bank's systems should be documented in a complete and concise manner and include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk are particularly significant and require substantiation by observation or testing.

POLICIES

1. Has the board of directors, consistent with its responsibilities, adopted written policies governing:
   a. Trading limits, including:
      - Overall trading volume?
      - Overnight net position limits per currency?
      - Intra-day net position limits per currency?
      - Aggregate net position limit for all currencies combined?
      - Maturity gap limits per currency?
      - Individual customer aggregate trading limits, including spot transactions?
      - Written approval of excesses to above limits?

   b. Segregation of duties among traders, bookkeepers and confirmation personnel?
   c. Accounting and revaluation procedures?
   d. Management reporting requirements?
2. Do policies attempt to minimize:
   a. Undue pressure on traders to meet specific budgeted earnings goals?
   b. Undue pressure on traders, by account officers, to provide preferred rates to certain customers?

*3. Are traders prohibited from dealing with customers for whom trading lines have not been established?

4. Are all personnel, except perhaps the head trader, prohibited from effecting transactions via off-premises communication facilities?
5. Is approval by a non-trading officer required for all compensated transactions?
6. Do credit approval procedures exist for settlement (delivery) risk either in the form of settlement limits or other specific management controls?
7. Does a policy procedure exist to ensure that, in case of an uncertain or emergency situation, the bank's delivery will not be made before receipt of counterpart funds?
8. Do the above policies apply to all branch offices as well as majority-owned or controlled subsidiaries of the bank?
9. Does the bank have written policies covering:
   a. Foreign exchange transactions with its own employees?
   b. Foreign exchange transactions with members of its board of directors?
   c. Its traders' personal foreign exchange activities?
   d. Its employees' personal business relationships with foreign exchange and money brokers with whom the bank trades?

*10. Are the above policies understood and uniformly interpreted by all traders as well as accounting and auditing personnel?

TRADING FUNCTION

11. Is a trader's position sheet maintained for each currency traded?

*12. Does management receive a trader's position report at the end of each trading day?

*13. Does the trader's position report reflect the same day's holdover and after-hours transactions?

14. Are trader's dealing tickets prenumbered?
   a. If so, are records and controls adequate to ascertain their proper sequential and authorized use?

   *b. Regardless of whether or not prenumbered,
      - Are dealing tickets time date stamped, as completed, or
      - Are dealing tickets otherwise identified with the number of the resultant contract to provide a proper audit trail?

ACCOUNTING AND REPORTING

*15. Is there a definite segregation of duties, responsibility and authority between the trading room and the accounting and reporting functions within the division and/or branch?

16. Are contract forms prenumbered (if so, are records and controls adequate to ensure their proper sequential and authorized use)?

17. Are contracts signed by personnel other than the traders?

*18. Are after-hours or holdover contracts posted as of the dates contracted?

*19. Do accounting personnel prepare a daily position report, for each applicable currency, from the bank's general ledger and:
   a. Do reports include all accounts denominated in foreign currency?
   b. Are those reports reconciled daily to the trader's position reports?
   c. Are identified or unreconciled differences reported immediately to management and to the head trader?
   d. Are all counterparty non-deliveries on expected settlements reported immediately to management and to the head trader?

*20. Are maturity gap reports prepared for liquidity and foreign exchange managers at least biweekly to include:
   a. Loans and deposits reflected in the appropriate forward maturity periods along with foreign exchange contracts?
   b. Loans, deposits and foreign exchange contracts (specify whether reflected in the maturity periods in which they fall due or in which they are scheduled for rollover ___________)?
   c. Commitments to accept or place deposits reflected in the appropriate maturity periods by both value and maturity dates?
   d. All those items (specify whether as of the day on which they mature or bi-weekly or monthly maturity periods ___________)?
   e. All those items as of the day on which they mature, if necessary, i.e., in the event of a severe liquidity situation?

*21. Does the accounting system render excesses of all limits identified at step 1 immediately to appropriate management and is officer approval required?

*22. Are local currency equivalent subsidiary records for foreign exchange contracts balanced daily to the appropriate general ledger account(s)?

*23. Are foreign exchange record copy and customer liability ledger trial balances prepared and reconciled monthly to subsidiary control accounts by employees who do not process or record foreign exchange transactions?

24. Do the accounting and filing systems provide for easy identification of ''financial swap'' related assets, liabilities and future contracts by stamping contracts or maintaining a control register?

CONFIRMATIONS

25. Is there a designated ''confirmation clerk'' within the accounting section of the division or branch?
   *a. Incoming confirmations:
      • Are incoming confirmations delivered directly to the confirmation clerk and not to trading personnel?
      • Are signatures on incoming confirmations verified with signature cards for:
         — Authenticity?
         — Compliance with advised signatory authorizations of the counterparty?
      • Are all data on each incoming confirmation verified with file copies of contracts to include:
         — Name?
         — Currency denomination and amount?
         — Rate?
         — Transaction date?
         — Preparation date if different from transaction date?
         — Maturity date?
         — Delivery instructions, if applicable?
      • Are discrepancies directed to an officer apart from the trading function for resolution?
      • Is a confirmation discrepancy log or other record maintained to reflect the identity and disposition of each discrepancy?

- Are telex tapes retained for at least 90 days as ready reference to rates and delivery instructions?

*b. Outgoing confirmations:
- Are outgoing confirmations mailed/telexed on the day during which each trade is effected?
- Are outgoing confirmations addressed to the attention of persons other than trading personnel at counterparty locations?
- Does the accounting and/or filing system adequately segregate and/or identify booked contracts for which no incoming confirmations have been received?
- Are follow-up confirmations sent by the confirmation clerk if no corresponding, incoming confirmation is received within a limited number of days after the contract is effected (if so, specify ___________)?
- Is involvement by the auditing department required if no confirmation is received within a limited number of days after the transmittal of the second request referred to above (if so, specify ___________)?
- Are confirmation forms sent in duplicate to customers who do not normally confirm?
- Are return copies required to be signed?

REVALUATIONS

*26. Are revaluations of foreign currency accounts performed at least monthly?

a. Does the revaluation system provide for segregation of and separate accounting for:
- Realized profits and losses, i.e., those which are determined through the application of spot rates?
- Unrealized profits and losses, i.e., those which are determined through the application of forward rates?

b. Are financial swap related assets, liabilities and future contracts excluded from the revaluation process so that the results identified in step 26a above more accurately reflect the trader's outright dealing performance?

c. Are financial swap costs and profits:
- Amortized over the life of the applicable swap?
- Appropriately accounted for as interest income and expense on loans, securities, etc?

d. Are rates provided by, or at least verified with, sources other than the traders?

OTHER

*27. Is the bank's system capable of adequately disclosing sudden increases in trading volume by any one trader?

28. Do such increases require officer review to insure that the trader is not doubling volume in an attempt to regain losses in his or her positions?

29. Does the bank retain information on, and authorizations for, all overdraft charges and brokerage bills within the last 12 months?

30. Does an appropriate officer review a comparison of brokerage charges, monthly, to determine if an inordinate share of the bank's business is directed to or handled by one broker?

CONCLUSION

31. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

32. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

International—Purchases, Sales, Trading, Swaps, Rentals, and Options of LDC Assets

Effective date September 1992

Section 7110.1

The prospects for full LDC debt repayment decreased during the mid-1980s because of depressed commodity prices and inflated interest rates. The market value of public and private sector LDC loans fell sharply below book value to the point where those loans became deeply discounted. A secondary market for trading LDC debt evolved and reached a degree of maturity in 1987 when banks significantly increased their loan loss reserves for their exposures to LDCs. Financial institutions in the United States and overseas, including commercial, merchant and investment banks, began to actively purchase, sell, swap and rent debt obligations of less developed countries for their own account and as intermediaries for others. U.S. multinational banks with significant LDC loan exposures established LDC trading units which initially had the primary responsibility to decrease the banks' LDC portfolios. As the secondary market matured, these units not only traded for their own accounts but became market makers and/or active participants in purchasing, selling, swapping and renting LDC debt. An options market based on LDC debt also is emerging.

The LDC debt market, once dismissed as illiquid, has evolved from a trickle of activity between 1985 through 1988, to a turnover of approximately $100 billion during 1990. This momentum is expected to continue as participants in this market have realized the potential for generating substantial profits in trading LDC debt. The majority of this paper is Latin American, followed by Eastern European and African obligations. Debt of approximately 30 countries in 300 instruments may be handled by an active participant.

The LDC trading arena includes a broad range of counterparties. Although multinational banks with significant LDC debt exposures are the most active participants in the market, the number of intermediaries and principals has grown substantially. International financial institutions, corporations, high net worth individuals and public sector entities are primarily engaged in buying, selling and renting LDC debt for their own account.

The price of LDC paper, which is almost always at a discount from face amount, may vary widely, depending on the issuer and maturity of the instrument and the country of risk. Prices (and liquidity) in the LDC debt market are influenced by a multitude of factors such as the ability/intent of public and private sector borrowers to service the debt, availability of debt-equity exchange programs, anticipated refinancing of existing debt programs and the underlying political and economic conditions in the developing countries.

Banks generally participate in this market to decrease their LDC exposures; however, some banks are also motivated to:

- Generate trading profits from the spread between the bid and offer prices
- Produce fee and commission revenues from acting as intermediaries for principals and brokers
- Participate in swap programs to facilitate debt/equity market development

Pricing, liquidity, potential conflicts of interest, violation of U.S. and foreign country laws and operational inefficiencies are the major problems faced by banks which are active market participants. The lack of liquidity in the secondary market for LDC paper could present a variety of risks to market participants. In the absence of depth in the market, the judgement of the trader is a significant factor in determining the current price of thinly traded issues. The reliance on one individual to determine prices and using those amounts to revalue the position, could result in under or overstating the profit and loss and the valuation of the position itself. A conflict of interest could result in potential future liability if there is no clear segregation of duties and responsibilities between a bank's trading in LDC assets and its role on debt renegotiation committees.

Access to LDC debt rescheduling information could give a bank unfair advantage over other creditor banks, which do not participate in the restructuring process. Another concern is the potential for a bank or its employees to knowingly or inadvertently violate U.S. or foreign country laws or aid or abet violations by its customers or trading partners. It is clear that banks have a responsibility to determine that they deal only with reputable counterparties. The relative newness of the market and the absence of industry guidelines pose challenges to both bank managements and the bank supervisory agencies.

International—Purchases, Sales, Trading, Swaps, Rentals, and Options of LDC Assets

Examination Objectives

Effective date September 1992

Section 7110.2

The objectives of conducting an examination of LDC asset purchases, sales, trading, swaps, rentals and options should include the following:

1. To determine if LDC asset purchases, sales, trading, swaps, rental and options policies, procedures and internal controls are adequate.
2. To evaluate the ability of the bank's reporting system to adequately monitor compliance to established policies, procedures and limits.
3. To review the bank's reporting system to determine whether it is adequate and effective.
4. To ascertain, to the extent possible, whether LDC trading activities are in compliance with applicable U.S. and local foreign laws.
5. To determine the extent of involvement by committees responsible for LDC trading activity in strategy and planning. For example, have contingency plans been developed if the need arises to liquidate a portfolio of LDC paper.
6. To identify potential conflicts of interest liability between those on committees for debt renegotiations or those acting as agents for the debtor country and those on the portfolio sales personnel and LDC debt traders.
7. To determine whether accounting procedures that have been established properly identify and account for loan sales, purchases, swaps, rentals and other LDC trading activity. Compare these accounting procedures to industry practices.
8. To ascertain that outstandings and traders' positions are reconciled to the official records of the bank.
9. To evaluate the LDC asset purchases, sales, trading, swaps or rentals for profitability.
10. To review the revaluation process utilized in determining profitability.
11. To determine the adequacy of the bank's risk management as it relates to LDC activities. Evaluate the bank's ability to monitor and control the following risks:
    a. Market risk
    b. Credit risk
    c. Settlement risk
    d. Liquidity risk
    e. Operational risk
    f. Legal risk
12. To review and assess the adequacy of the audit coverage with respect to the frequency and scope of the audit program, experience of auditors, quality of audit reports and effectiveness of management follow-up. Determine the extent of the outside accountants involvement in reviewing these activities.
13. To determine if sufficient legal documentation exists to establish an enforceable agreement, and to ascertain the nature of and purpose behind the underlying transaction.
14. To review the bank's procedures for conducting due diligence on nonbank parties.
15. To determine the sufficiency of the bank's transaction files.
16. To determine if the bank allows sales, borrowing or substitutions from its loan portfolio to its trading positions. If yes, how is the pricing on the loan portfolio done? Does the bank have the proper accounting and tracking procedures in place?
17. To review any unusual charges/fees and any split of fees or unusual destination of a payment.
18. To review margin lending practices and policies of banks offering financing to customers dealing in LDC debt.
19. To review bank's policies and procedures regarding traders' ability to trade in LDC debt for their own personal account to ensure that adequate controls are in place to avoid conflicts of interest and diversion of bank's corporate opportunities to traders' personal benefit.

International—Purchases, Sales, Trading, Swaps, Rentals, and Options of LDC Assets
Examination Procedures
Effective date September 1992

Section 7110.3

An examination of a bank's LDC asset purchases, sales, trading, swaps, rental, and options program should focus on written policies, accounting, management reporting, conflict of interest, risk management, and internal controls. In addition, the examiners should address the general nature, volume and importance of these activities.

1. Evaluate the adequacy of the bank's written policies regarding its LDC trading activity and determine whether:
   a. The objectives, strategy and philosophy adhere to those approved by the bank's board of directors.
   b. All documentation and legal requirements (both local and foreign) regarding this activity have been addressed.
   c. An approval process has been established to execute unusual or complex transactions in LDC paper that lacks liquidity or has some unusual feature.
   d. The policy stipulates the options available if the need arises to remove the asset from inventory.
2. Review the bank's accounting policy for LDC transactions.
   a. Review the accounting and reporting guidelines to assure that all aspects of this activity are captured on the books of the bank.
   b. Review the subsidiary ledgers and reconcile these with the general ledger and contingent accounts.
   c. Reconcile the traders position sheet with the general ledger accounts.
   d. Review the accounting procedures governing the bank borrowing LDC debt from its own portfolio and purchasing or borrowing from a third party.
   e. Determine if the revaluation process is conducted separately from the trading process and that the resultant gains or losses are properly recorded.
3. Determine whether the bank has addressed the ''conflict of interest'' issue sufficiently, so that trading activities are not being influenced by other areas of the bank that may be negotiating debt restructuring activities or that may have provided advice to such country on financial or economic matters. Are the same individuals participating as members of a debt renegotiating committee or acting in an agency capacity for the debtor country also involved in or communicating with those trading, swapping and renting LDC debt?
   a. Does the policy address all the roles that the bank performs? Has management established procedures to identify the responsibility of renegotiating committee members, agency personnel, portfolio sales personnel and LDC debt traders?
4. Review the bank's procedures to ensure that it is complying with local and sovereign laws.
   a. Is the bank aware of local and foreign laws governing the trading of a particular country's debt? Are there records demonstrating that legal personnel are reviewing transactions to determine compliance with U.S. and foreign laws? To what extent is this information disseminated to traders?
   b. Is the bank assuring itself that trading partners are not violating these laws or are using the bank to circumvent compliance with applicable laws and regulations?
5. Evaluate management's understanding of the risks associated with LDC asset purchases, sales, trading, swaps, options and rentals. Determine whether all risks have been considered and assess management's ability to monitor and control them. The following risks should be considered:
   a. *Market Risk*—The relevant risk interval for counterparty exposure is the time period from trade date to final settlement date. The exposure is a function of the change in the price during the risk interval. Determine how the bank monitors and controls its exposure to an increase in price, if it is buying, and decrease in price, if selling.
   b. *Credit Risk*—Does the bank require credit approval from appropriate lending officers for each counterparty? Review counterparty credit lines for proper approval.

Review margin lending practices as related to LDC debt sales.

c. *Settlement Risk*—While it occurs only when purchasing LDC assets, examiners should determine how the bank protects itself from this risk.
d. *Liquidity Risk*—Have restrictions been placed on dealing in LDC debt which is not actively traded?
e. *Operating Risk*—Review the bank's policies and procedures for deficiencies. Assure that all operating groups supporting this activity are adhering to established guidelines.
f. *Legal Risk*—Has counsel reviewed all segments of this activity from a legal perspective?

6. Determine whether the bank's LDC trading activities are subject to regular audits.
   a. Obtain copies of all recent audits and review their findings;
   b. Determine whether the audit procedures covering these activities are sufficiently comprehensive; and
   c. Determine whether management has taken appropriate action to resolve significant audit concerns.
7. Evaluate the bank's internal control policies and procedures with emphasis on:
   a. Are traders' lines and LDC debt limits established by country, type of paper and customer?
   b. Are limits established by credit officers who are independent of the LDC trading function?
   c. Determine that exceptions to established limits have been properly reported and approved.
8. Evaluate the policies and procedures governing traders' behavior:
   a. What type of controls are in place with regard to after hour trading?
   b. Describe the bank's procedures for recording phone conversations. Are traders permitted to override the recording devices? How long are these recordings retained?
   c. Describe the bank's policy regarding traders' remuneration.
   d. What types of procedures and policies have the bank implemented to address self-dealing in LDC debt by traders?
   e. In what manner are the traders educated about the bank's policies and procedures?
9. Describe the type of LDC transactions entered into by the bank:
   a. Does the bank engage in fronting (i.e., sales of participations, etc.) transactions? When engaging in fronting transactions, does the bank conduct the proper legal analysis regarding whether such transaction would violate any U.S. or foreign laws or restructuring agreements? Does the bank inquire as to the customer's purpose for acquiring LDC debt in fronting transactions?
   b. Does the bank engage in parking transactions through a third party or another banking unit? Does the bank permit other financial institutions to park debt with it?
10. Evaluate the private banking unit/group's involvement in LDC transactions:
    a. How are the private banking clients obtained?
    b. What types of LDC transactions does the bank enter into for its private banking clients? Does the bank inquire as to purpose of transactions entered into for private banking clients?
    c. What type of scrutiny is performed to assure that the bank "knows its private banking clients?"
11. Describe the types of fees which the bank pays when engaging in LDC transactions:
    a. What are the amounts of broker fees? Are these fees easily determinable? Are these fees in line with the industry practices?
    b. Does the bank have any other type of fee arrangements (i.e., specially negotiated fees, partnerships, etc.)?
    c. Has the bank diversified its use of brokers adequately?
12. Evaluate broker involvement in the LDC trading activity and review the fee structure on transactions.

FIRST-DAY LETTER

Please provide the following information regarding your bank's LDC asset sales, purchases, swaps, options, and rental programs as of (*examination date*).

1. A complete inventory, broken down by country, of all LDC paper held in the trading account and the investment account.
2. A listing of all sales/purchases of LDC paper that identifies the assets or commitments sold/bought and inventory by (a) obligor, (b) face amount, (c) maturity, (d) price, (e) closing date, (f) counterparty names, and (g) the names and address of the assignor and assignee.

   Sales from the bank's own portfolio should be reported separately from transactions of the LDC trading unit.
3. Listing of all rentals of and options held on LDC paper.
4. A copy of the bank's specific policies and procedures for LDC asset purchases, sales, swaps, options and rentals.
5. A copy of all rules of conduct, procedures and policies governing LDC activities.
6. An organizational chart and the names and titles of individuals designated as responsible for LDC trading activities.
7. A listing and brief description of all management information reports covering these activities and copies of these reports.
8. Describe accounting policies and operating procedures if the LDC trading unit borrows from the bank's loan portfolio to effect delivery or borrows/lends LDC debt from/to third parties.
9. Information broken down by trading location/profit center showing the volume of LDC assets purchased, sold, swapped and rented during the two prior years, the current year to date and a projection of the volume of activity for the balance of this year and next year.
10. A listing of all limits, including the bank's overall inventory limit, country limits, type of paper limit, customer settlement limit and trader limits. Indicate the policy regarding the review dates of limits. A list of any exception reports to these limits and management's responses to exceptions.
11. A listing of principal counterparties and approved counterparty lines.
12. A list of brokers used and indicate the approximate percentage of total business conducted with each and the fees paid to such brokers.
13. Copies of any standard documents used by the bank in its LDC asset sales, purchases, swaps and rentals.
14. A copy of trading policies. If the bank is a market maker, list the type of LDC debt in which it makes a market.
15. A listing of all general ledger contingency and memoranda accounts, income and expense accounts to record LDC asset sales, swaps and renting transactions.
16. Income and expenses of LDC trading activities for the two prior years and year-to-date.
17. Copies of the most recent audit reports conducted by both the internal and external auditors, including management responses on the bank's LDC asset trading activities.
18. A copy of the internal and external audit programs and procedures used for the audits of these activities.
19. If conducted outside of the United States, any information submitted to local regulatory authorities regarding the LDC trading function should be requested.
20. Copies of any legal opinions rendered on specific transactions and a list of any pending litigations.
21. A copy of the industry association's rules and regulations.